Internal Revenue bulletin

Bulletin No. 2003-43
October 27, 2003

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 9089, page 906.
REG–132760–03, page 933.

Temporary and proposed regulations under section 1502 of the Code provide guidance concerning how a corporation that is a member of a consolidated group reduces its tax attributes when that member realizes discharge of indebtedness income that is excluded from gross income under section 108.

T.D. 9090, page 891.
REG–141402–02, page 932.

Temporary and proposed regulations under section 448(d)(5) of the Code provide guidance regarding the use of a nonaccrual-experience method by taxpayers using an accrual method of accounting and performing services. A public hearing on the proposed regulations is scheduled for December 10, 2003. Notice 2003–12 obsoleted. Rev. Proc. 2002–9 modified.

Notice 2003–71, page 922.

Section 1(h) of the Code provides that certain dividends paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation" are subject to tax at the reduced rates applicable to certain capital gains. The term "qualified foreign corporation" is defined to include possessions corporations and certain foreign corporations that are eligible for benefits of certain United States income tax treaties. A foreign corporation that is not otherwise treated as a qualified foreign corporation will be so treated with respect to any dividend it pays if the stock with respect to which the dividend is paid is readily tradable on an established securities market in the United States. This notice defines, for dividends received on or after January 1, 2003, what it means to be readily tradable on an established securities market in the United States.

EXEMPT ORGANIZATIONS

Announcement 2003–64, page 934.

Steve Brashen Foundation of Bellevue, WA, Clove Hitch Foundation, Inc., of Pompano Beach, FL, and Spring Assistance for Educators of Houston, TX, no longer qualify as organizations to which contributions are deductible under section 170 of the Code.

EMPLOYMENT TAX

Notice 2003–70, page 916.

This notice contains a proposed revenue procedure giving updated guidance to state and local government agencies on how they can serve as employment tax agents, under section 3504 of the Code, for participants in state or local government programs who employ home-care service providers to assist them in their homes. The Service seeks comments on the proposed revenue procedure. Notice 95–18 modified. Rev. Proc. 70–6 modified and superseded, in part. Rev. Proc. 80–4 modified and amplified.

ADMINISTRATIVE

Rev. Proc. 2003–74, page 923.

This procedure revokes revenue procedures which describe procedures previously used by the Service for providing copies of returns and return information pursuant to sections 6103 and 6104 of the Code, and states where the current procedures are published. Rev. Procs. 66–3, 84–71, 85–56, 87–21, 94–52, and 97–11 revoked.

(Continued on the next page)

Announcement of Declaratory Judgment Proceedings Under Section 7428 begins on page 935.
Finding Lists begin on page ii.
Index for July through October begins on page x.

Department of the Treasury
Internal Revenue Service

Rev. Proc. 2003–76, page 924.

Optional standard mileage rates. This procedure announces 37.5 cents as the optional rate for deducting or accounting for expenses for business use of an automobile, 14 cents as the optional rate for use of an automobile as a charitable contribution, and 14 cents as the optional rate for use of an automobile as a medical or moving expense for 2004. It provides rules for substantiating the deductible expenses of using an automobile for business, moving, medical, or charitable purposes. The procedure also revises the limitation on simultaneous use of multiple automobiles to allow a taxpayer using up to four vehicles simultaneously to use the standard mileage rate. Rev. Proc. 2002–61 superseded.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.*

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

* **Beginning with Internal Revenue Bulletin 2003–43**, we are publishing the index at the end of the month, rather than at the beginning.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.

Rules are provided under which a reimbursement or other expense allowance arrangement for the cost of operating an automobile for business purposes will satisfy the requirements of section 62(c) of the Code as to business connection, substantiation, and returning amounts in excess of expenses. See Rev. Proc. 2003-76, page 924.

Section 162.—Trade or Business Expenses

26 CFR 1.162–17: Reporting and substantiation of certain business expenses of employees.

Rules are provided for substantiating the amount of a deduction or an expense for business use of an automobile that most nearly represents current costs. See Rev. Proc. 2003-76, page 924.

Section 170.—Charitable, etc., Contributions and Gifts

26 CFR 1.170A–1: Charitable, etc., contributions and gifts; allowance of deduction.

Rules are provided for substantiating the amount of a deduction or an expense for charitable use of an automobile. See Rev. Proc. 2003-76, page 924.

Section 213.—Medical, Dental, etc., Expenses

26 CFR 1.213–1: Medical, dental, etc., expenses.

Rules provided forth for substantiating the amount of a deduction or an expense for use of an automobile to obtain medical services. See Rev. Proc. 2003-76, page 924.

Section 217.—Moving Expenses

26 CFR 1.217–2: Moving expenses.

Rules are set forth for substantiating the amount of a deduction or an expense for use of an automobile as part of a move. See Rev. Proc. 2003-76, page 924.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

26 CFR 1.274–5: Substantiation requirements.

Rules are provided for substantiating the amount of ordinary and necessary business expenses of an employee for automobile expenses when a payor provides a mileage allowance for such expenses. Rules are also provided for employees and self-employed individuals to use in substantiating a trade or business deduction for automobile expenses. See Rev. Proc. 2003-76, page 924.

Section 448.—Limitation on Use of Cash Method of Accounting

26 CFR 1.448–2T: Nonaccrual of certain amounts by service providers (temporary).

T.D. 9090

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Limitation on Use of the Nonaccrual-Experience Method of Accounting Under Section 448(d)(5)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document revises temporary income tax regulations to provide guidance regarding the use of a nonaccrual-experience method of accounting by taxpayers using an accrual method of accounting and performing services. The revisions reflect changes to section 448(d)(5) of the Internal Revenue Code by the Job Creation and Worker Assistance Act of 2002. The revised temporary regulations will affect taxpayers that no longer qualify to use a nonaccrual-experience method of accounting, and qualifying taxpayers that wish to adopt or change a nonaccrual-experience method of accounting. The text of these temporary regulations also serves as the text of the proposed regulations (REG–141402–02) set forth in this issue of the Bulletin.

DATES: *Effective Date*: These regulations are effective September 4, 2003.

Applicability Date: These regulations are applicable for taxable years ending after March 9, 2002.

FOR FURTHER INFORMATION CONTACT: Terrance McWhorter, (202) 622–4970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1855. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 448(d)(5). Section 448(d)(5) was added to the Code by section 801 of the Tax Reform Act of 1986

(Public Law 99–514, 100 Stat. 2085) and was amended by section 403 of the Job Creation and Worker Assistance Act of 2002 (Public Law 107–147, 116 Stat. 21) (the 2002 Act), effective for taxable years ending after March 9, 2002. These regulations pertain to the nonaccrual of certain amounts by taxpayers using an accrual method of accounting and performing services.

Explanation of Provisions

Background

Prior to being amended by the 2002 Act, pursuant to section 448(d)(5) taxpayers using an accrual method of accounting and performing services were not required to accrue any portion of their service-related income that, on the basis of their experience, would not be collected. Temporary regulations under section 448(d)(5) (former temporary regulations) provided rules for the nonaccrual of certain amounts by service providers, including the use of experience to estimate uncollectible amounts and the mechanics of the nonaccrual-experience method.

Section 448(d)(5) was amended by section 403 of the 2002 Act, effective for taxable years ending after March 9, 2002. Section 448(d)(5) now provides that a nonaccrual-experience method is available only for taxpayers using an accrual method who either provide services in fields described in section 448(d)(2)(A) (*i.e.*, health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting), or that meet the $5 million annual gross receipts test of section 448(c) for all prior taxable years.

The legislative history of the 2002 Act states that Congress believed that for many qualified service providers the formula contained in the former temporary regulations under section 448(d)(5) may not clearly reflect the amount of income that, based on experience, will not be collected. See H.R. Rep. No. 107–251. Congress noted that service providers were particularly disadvantaged by the formula contained in the former temporary regulations if significant time elapsed between the time the services were rendered and the time a final determination was made that the account would not be collected. Additionally, Congress noted that taxpayers qualified to use the nonaccrual-experience method of accounting should not be subject to a formula that required the payment of taxes on receivables that would not be collected.

The amendments to section 448(d)(5) made by the 2002 Act require the Secretary to promulgate regulations. Specifically, the Secretary is required to prescribe regulations to permit a taxpayer to use computations or formulas that, based on experience, accurately reflect the amount of income that will not be collected. Section 448(d)(5), as amended, also permits a taxpayer to adopt, or request consent of the Secretary to change to, a computation or formula that clearly reflects the taxpayer's experience. Section 448(d)(5) further requires the Secretary to approve a request to change to a computation or formula that clearly reflects the taxpayer's experience. Lastly, the legislative history to the 2002 Act states that Congress anticipated that the Secretary would consider providing safe harbors in such regulations that may be relied upon by taxpayers.

In accordance with the amendments to section 448(d)(5) in the 2002 Act, the IRS issued Notice 2003–12, 2003–6 I.R.B. 422, to provide interim guidance under section 448(d)(5), as amended, pending the issuance of new regulations. The interim guidance provided by Notice 2003–12 included: (1) for taxpayers that no longer qualified to use a nonaccrual-experience method, procedures to change their method of accounting; (2) for taxpayers that qualified to use a nonaccrual-experience method, two safe harbor nonaccrual-experience methods that were presumed to clearly reflect the taxpayer's nonaccrual-experience; (3) for taxpayers that qualified to use a nonaccrual-experience method but wished to compute their nonaccrual-experience using a formula other than the two safe harbors provided, the requirements necessary to use an alternative formula to compute their nonaccrual-experience; and (4) for taxpayers that wished to change to a different nonaccrual-experience method, the procedures necessary to obtain automatic consent of the Commissioner to change to one of the safe harbor nonaccrual-experience methods or to an alternative nonaccrual-experience method that clearly reflected their experience.

The guidance provided in Notice 2003–12 has, for the most part, been incorporated as part of these temporary regulations. However, certain provisions in the notice have been modified to address certain concerns raised by the commentators.

Charging Of Interest

Section 448(d)(5) and the former temporary regulations provide that a nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid or for which there is any penalty for failure to timely pay any amounts due (other than, in certain circumstances, discounts offered for early payment of an amount due). One commentator suggested that a taxpayer should not be precluded from using a nonaccrual-experience method of accounting if the taxpayer's agreement contains a provision stating that interest is required to be paid but the taxpayer rarely enforces the provision. The IRS and Treasury Department continue to believe that if a taxpayer's agreement requires interest to be paid, or provides for any penalty for failure to timely pay any amounts due, such taxpayer is precluded from using the nonaccrual-experience method of accounting, regardless of whether the taxpayer actually imposes such interest or penalty.

Safe Harbor Methods

The temporary regulations include the two safe harbor nonaccrual-experience methods that were included in Notice 2003–12. The first safe harbor method (safe harbor 1) is the method provided in former Temp. Reg. §1.448–2T(e)(2). The second safe harbor method (safe harbor 2) is the actual experience method that may be computed using a three-year moving average beginning in the first taxable year this safe harbor method is used or, for taxpayers that do not have the information necessary to compute a three-year moving average in the first taxable year this method is used, the option of creating a three-year moving average beginning with the first taxable year that the taxpayer uses this safe harbor method. A newly formed taxpayer choosing the option of creating a three-year moving average that does not have any accounts receivable upon formation will not be able to exclude any portion of its year-end accounts receivable from income for its first taxable year because the taxpayer does not have any accounts receivable on the first day of the taxable year to track. Thus, a newly formed taxpayer that does not have any accounts receivable upon formation must begin creating its three-year moving average in its second taxable year.

Commentators requested that the IRS and Treasury Department consider other suggested alternative safe harbor methods for inclusion in the temporary regulations. The IRS and Treasury Department analyzed alternative methods and, based on this analysis, have determined that two other formulas will clearly reflect a taxpayer's nonaccrual-experience. As a result, the temporary regulations provide two additional safe harbor nonaccrual-experience methods that may be relied on by taxpayers as clearly reflecting their nonaccrual-experience.

The third safe harbor method (safe harbor 3) is a variation of the formula addressed in *Black Motor Co. v. Commissioner*, 41 B.T.A. 300 (1940), *aff'd*, 125 F.2d 977 (6th Cir. 1942). The nonaccrual-experience amount is computed by first determining the ratio of total bad debts charged off (adjusted for recoveries) for the current taxable year and the five preceding taxable years as compared to the total accounts receivable at the end of the current taxable year and the five preceding taxable years. This ratio is applied against the accounts receivable balance at the end of the current taxable year, and the resulting amount is then reduced by the credit charges (accounts receivable) generated and written off during the current taxable year, which results in the nonaccrual-experience amount for the current taxable year.

The fourth safe harbor method (safe harbor 4) is computed by first determining the ratio of total bad debts charged off (adjusted for recoveries) for the current taxable year and the five preceding taxable years other than the credit charges (accounts receivable) that were charged off in the same taxable year they were generated as compared to the total accounts receivable at the end of the current taxable year and the five preceding taxable years. This ratio is then applied against the accounts receivable balance at the end of the current taxable year, which results in the nonaccrual-experience amount for the current taxable year.

Commentators suggested that the IRS and Treasury Department permit the formula addressed in *Black Motor* ("Black Motor formula") as an additional safe harbor formula in the temporary regulations. The IRS and Treasury Department have analyzed the Black Motor formula and have determined that the formula should not be provided as an additional safe harbor formula because the formula only produces an accurate reflection of a taxpayer's experience in limited circumstances. The IRS and Treasury Department believe that safe harbors 3 and 4 (discussed above), which are modifications of the Black Motor formula, remedy many of the shortcomings of the Black Motor formula and, as a result, safe harbors 3 and 4 have been included in the temporary regulations as additional safe harbor formulas.

The IRS and Treasury Department request comments on these safe-harbor nonaccrual-experience methods and suggestions on any additional safe harbor methods that will clearly reflect a taxpayer's experience. Specifically, the IRS and Treasury Department request comments on any additional modification to the Black Motor formula that will result in an accurate reflection of a taxpayer's experience.

Self-Testing Of Any Alternative Method

Notice 2003–12 also allowed a taxpayer to use any alternative nonaccrual-experience method that clearly reflected the taxpayer's actual nonaccrual-experience, provided the taxpayer's alternative nonaccrual-experience method was "self-tested" in the first taxable year ending after March 9, 2002, in which the taxpayer uses the alternative nonaccrual-experience method and every three taxable years thereafter. The notice provided that if the taxpayer's total alternative nonaccrual-experience amount for the test period was less than or equal to the total adjusted nonaccrual-experience amount (actual nonaccrual-experience amount multiplied by 105%) for the test period, then the taxpayer's alternative nonaccrual-experience method would be treated as clearly reflecting its nonaccrual-experience for the test period and the taxpayer would be permitted to continue using the alternative nonaccrual-experience method, subject to self-testing again in three taxable years. However, if the taxpayer's total alternative nonaccrual-experience amount for the test period was greater than the total adjusted nonaccrual-experience amount for the test period, the notice stated that the taxpayer's alternative nonaccrual-experience method would be treated as not clearly reflecting its nonaccrual-experience for the test period and the taxpayer was required to change its nonaccrual-experience method of accounting to a method that would clearly reflect its nonaccrual experience.

Some commentators suggested that the self-testing requirement in Notice 2003–12 should not be included in the regulations. They suggested that the self-testing requirement is inconsistent with the language and purpose of the amendments made by the 2002 Act. The commentators also suggested that it would be burdensome and impractical for many taxpayers using an alternative nonaccrual-experience method to conduct the self-test due to the limitations of their existing automated record keeping systems. Finally, one commentator suggested that if a taxpayer's alternative nonaccrual-experience method fails the self-testing requirements, then the temporary regulations should limit the taxpayer's exclusion under section 448(d)(5) to the taxpayer's adjusted nonaccrual-experience amount, rather than require the taxpayer to change its method of accounting.

The IRS and Treasury Department believe that the self-testing requirement is consistent with the 2002 Act, which provides that "[a] taxpayer may adopt, or . . . change to, a computation or formula that clearly reflects the taxpayer's experience," and that "[a] request [to change] shall be approved if such computation or formula clearly reflects the taxpayer's experience." Public Law No. 107–147, § 403(a). The IRS and Treasury Department believe that self-testing is necessary for taxpayers that do not use one of the four safe harbor methods provided to ensure that the statutory requirement that the taxpayer's formula or computation accurately reflect the taxpayer's nonaccrual experience is met. Therefore, the temporary regulations continue to permit a taxpayer to use any alternative nonaccrual-experience method, provided such method meets the self-testing requirements described in the temporary regulations. The IRS and Treasury Department welcome comments from taxpayers and practitioners specifically addressing the limitations of their record keeping systems that affect conducting self-testing, and ways in which the burden on taxpayers of self-testing might be reduced without compromising the statute's requirement that the taxpayer's method clearly reflect the taxpayer's experience.

Under the temporary regulations, taxpayers using (or desiring to use) an alternative nonaccrual-experience method must self-test the method in the first taxable year ending after March 9, 2002, that the taxpayer uses, or desires to use, the method (first-year self-test), and every three taxable years thereafter (three-year self-test). When conducting the first-year self-test, a taxpayer is permitted to test its alternative nonaccrual-experience method against any of the four safe harbor methods. If a taxpayer is permitted to use its alternative nonaccrual-experience method as a result of satisfying the first year self-test, the temporary regulations require the taxpayer to include contemporaneous documentation in its books and records stating which safe harbor method was used during the self-test that permitted the taxpayer to use its alternative nonaccrual-experience method. When conducting any three-year self-test, the taxpayer must self-test its alternative nonaccrual-experience method against the same safe harbor method used during the immediately preceding self-test. The temporary regulations also provide rules for taxpayers that want to change the safe harbor method used to test their alternative nonaccrual-experience method.

For purposes of the first-year self-test, if the alternative nonaccrual-experience amount for the first-year self-test is less than or equal to the nonaccrual-experience amount computed under the safe harbor formula selected by the taxpayer for the first-year self-test, then the taxpayer's alternative nonaccrual-experience method will be treated as clearly reflecting its nonaccrual-experience for the test period and the taxpayer may continue to use that alternative nonaccrual-experience method, subject to a requirement to self-test again after three taxable years. If the alternative nonaccrual-experience amount is greater than the nonaccrual-experience amount of the safe harbor method selected by the taxpayer for its self-test method, then the taxpayer's alternative nonaccrual-experience method will be treated as not clearly reflecting its nonaccrual-experience for such taxable year and the taxpayer will not be permitted to use that alternative nonaccrual-experience method for such taxable year. The taxpayer is permitted, however, to adopt (or change to) a safe harbor nonaccrual-experience method provided in the regulations or another alternative nonaccrual-experience method, subject to the first-year self-test requirement.

For purposes of the three-year self-test requirement, if the cumulative alternative nonaccrual-experience amount for the test period is less than or equal to the cumulative nonaccrual-experience amount (computed by using for each taxable year of the test period the safe harbor formula used, and contemporaneously documented, during the immediately preceding self-test) (cumulative safe harbor nonaccrual-experience amount), then the taxpayer's alternative nonaccrual-experience method will be treated as clearly reflecting its nonaccrual experience for the test period and the taxpayer may continue to use that alternative nonaccrual-experience method, subject to a requirement to self-test again in three taxable years. If the cumulative alternative nonaccrual-experience amount for the test period is greater than the cumulative safe harbor nonaccrual-experience amount, then the taxpayer's alternative nonaccrual-experience amount will be limited to the cumulative safe harbor nonaccrual-experience amount for the test period. Any excess of the taxpayer's cumulative alternative nonaccrual-experience amount excluded from income during the test period over the taxpayer's cumulative safe harbor nonaccrual-experience amount must be recaptured into income in the third taxable year of the three-year self-test. The taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement.

The IRS and Treasury Department request comments on the first-year self-test, three-year self-test, and recapture provisions of the temporary regulations.

Special Rules

Notice 2003–12 provided that a taxpayer that did not maintain records of the data necessary to determine its actual nonaccrual-experience would be subject to being changed by the IRS on examination to the specific charge-off method. One commentator noted that a taxpayer should not be changed by the IRS to the specific charge-off method merely because of unintentional and/or immaterial variances between the methods permitted under these regulations and the taxpayers' computations, which are often due to factors beyond the taxpayer's control. Among the factors noted were inherent delays between the time services were rendered and when actual billing occurs (which may affect the determination of the year-end balance of accounts receivable, especially when services are provided at the end of one taxable year and the billing occurs a few days later in the subsequent taxable year), and constraints of the taxpayer's computer systems that limit the taxpayer's ability to maintain the data necessary for a nonaccrual-experience method. For example, a taxpayer may be unable to determine whether a particular recovery relates to an account receivable on hand at the beginning of the taxable year. The commentator noted that a taxpayer may therefore choose to treat all recoveries as relating to an account receivable on hand at the beginning of the taxable year, which under safe harbor 2, reduces the nonaccrual-experience amount that the taxpayer would be entitled to if the taxpayer precisely allocated its recoveries. Because these factors generally will result in a taxpayer claiming less than the proper nonaccrual-experience amount the taxpayer would otherwise be entitled to, the commentator requested that the IRS not change a taxpayer to the specific charge-off method due to variances similar to those noted above.

The IRS and Treasury Department do not intend that a taxpayer be changed to the specific charge-off method due to unintentional and/or immaterial variances, especially if a taxpayer is disadvantaged by such variances. As a result, the temporary regulations require only that a taxpayer maintain records that are sufficient to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year. This rule is consistent and in accordance with §1.6001–1(a) (rules regarding records). However, the IRS maintains the right to change a taxpayer to the specific charge-off method if such taxpayer fails to maintain sufficient records to establish the amount of any claimed exclusion from gross income under section 448(d)(5) for the taxable year. The IRS and Treasury Department request comments on this record keeping standard.

Periodic Systems

Notice 88–51, 1988–1 C.B. 535, provides guidance on the use of a periodic system of applying the nonaccrual-experience method provided in former Temp. Reg. §1.448–2T(e)(2). The periodic system entails establishing an account based on the aggregate amount of accounts receivable that: (1) are eligible for the nonaccrual-experience method; and (2) the taxpayer estimates will not be collected. The account is adjusted each year to reflect the taxpayer's estimate (using its nonaccrual-experience method) of the aggregate amount of the accounts receivable outstanding at year-end that will not be collected. A corresponding adjustment is then made to gross income.

The IRS and Treasury Department intend to update Notice 88–51 to provide for the use of a periodic system by taxpayers using any nonaccrual-experience method. Pending the issuance of this guidance, a taxpayer may use the periodic system described in Notice 88–51 in conjunction with any permissible nonaccrual-experience method used by the taxpayer.

Accounting Method Change Procedures

A change from a nonaccrual-experience method by a taxpayer no longer qualified to use such a method, a change to a nonaccrual-experience method, a change from one nonaccrual-experience method to another nonaccrual-experience method, or a change from using one safe harbor method for self-testing to another safe harbor method, is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder, apply. The temporary regulations provide, in most instances, automatic consent for these changes. Taxpayers making these changes should follow the procedures of Rev. Proc. 2002–9. Additionally, the temporary regulations provide automatic consent procedures for taxpayers changing to a nonaccrual-experience method to also request to change to a periodic system.

Additional Issues to be Addressed in Final Regulations

The IRS and Treasury Department intend to address additional issues in future guidance that are not addressed in these temporary regulations. Specifically, the IRS and Treasury Department request comments on the effect on the computation of a taxpayer's nonaccrual-experience as a result of a short taxable year, and an acquisition or disposition of an entity during a taxable year, including the acquisition or disposition of an entity disregarded for federal income tax purposes. The IRS and Treasury Department also request comments on whether the computation under the Actual Experience Method should be based on the prior three taxable years or, as currently provided, the current taxable year and the two immediately preceding taxable years.

Effect on Other Documents

The following publication is obsolete as of September 4, 2003:

Notice 2003–12, 2003–6 I.R.B. 422.

The following publication is modified to include in Section 5.06 of the Appendix as of September 4, 2003, only the changes in method of accounting provided in §1.448–2T(g)(2)(ii), (g)(3)(i) and (h):

Rev. Proc. 2002–9, 2002–1 C.B. 327.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For application of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

The principal author of these regulations is Terrance McWhorter of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.448–2T is revised as follows:

§1.448–2T Nonaccrual of certain amounts by service providers (temporary).

(a) *In general*. This section applies to taxpayers qualified to use a nonaccrual-experience method of accounting provided for in section 448(d)(5) with respect to amounts to be received for the performance of services. Except as otherwise provided in this section, a taxpayer is qualified to use a nonaccrual-experience method of accounting if the taxpayer uses an accrual method of accounting with respect to amounts to be received for the performance of services by the taxpayer and either—

(1) The services are in fields referred to in section 448(d)(2)(A) and as described in §1.448–1T(e)(4) (*i.e.*, health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting); or

(2) The taxpayer meets the $5 million annual gross receipts test of section 448(c) and §1.448–1T(f)(2) for all prior taxable years.

(b) *Nonaccrual-experience method; treatment as method of accounting*. Any taxpayer who satisfies the requirements of this section is not required to accrue any portion of amounts to be received from the performance of services that, on the basis of such person's experience, and to the extent determined under the computation or formula used by the taxpayer and allowed under this section, will not be collected. This nonaccrual of amounts to be received for the performance of services shall be treated as a method of accounting under the Code (a nonaccrual-experience method).

(c) *Method not available if interest charged on amounts due*. A nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid or for which there is any penalty for failure to timely pay any amounts due. For this purpose, the taxpayer will be treated as charging interest or penalties for late payment if the contract or agreement expressly provides for the charging of interest or penalties for late payment, regardless of the practice of the parties. If the contract or agreement does not expressly provide for the charging of interest or penalties for late payment, the determination of whether the taxpayer charges interest or penalties for late payment will be made based on all of the facts and circumstances of the transaction, and not merely on the characterization by the parties or the treatment of the transaction under state or local law. However, the offering of a discount for early payment of an amount due will not be regarded as the charging of interest or penalties for late payment under this section, if—

(1) The full amount due is otherwise accrued as gross income by the taxpayer at the time the services are provided; and

(2) The discount for early payment is treated as an adjustment to gross income in the year of payment, if payment is received within the time required for allowance of such discount. See paragraph (f) *Example 1* of this section for an example of this rule.

(d) *Method not available for certain receivables*—(1) *Amounts earned and recognized through the performance of services*. A nonaccrual-experience method of accounting may be used only with respect to amounts earned by the taxpayer and otherwise recognized in income (an account receivable) through the performance of services by such taxpayer. For example, a nonaccrual-experience method may not be used with respect to amounts owed to the taxpayer by reason of the taxpayer's activities with respect to lending money, selling goods, or acquiring accounts receivable or other rights to receive payment from other persons (including persons related to the taxpayer) regardless of whether those persons earned such amounts through the provision of services.

(2) *Special rule*. Except as otherwise provided, for purposes of this section, accounts receivable do not include amounts that are not billed (*e.g.*, for charitable or *pro bono* services) or amounts contractually not collectible (*e.g.*, amounts in excess of a fee schedule agreed to by contract). See paragraph (f) *Examples 2* and *3* of this section for examples of this rule.

(e) *Use of experience to estimate uncollectible amounts*—(1) *In general*. In determining the portion of any amount due which, on the basis of experience, will not be collected, the taxpayer may use one of four safe harbor nonaccrual-experience methods of accounting provided in paragraphs (e)(2) through (e)(5) of this section. Alternatively, the taxpayer may use any other nonaccrual-experience method ("alternative nonaccrual-experience method") that clearly reflects the taxpayer's nonaccrual-experience, subject to the requirements of paragraph (e)(6) of this section. The safe harbor nonaccrual-experience methods provided in paragraphs (e)(2) through (e)(5) of this section will be presumed to clearly reflect a taxpayer's nonaccrual-experience. For purposes of determining a taxpayer's nonaccrual-experience under any method provided in this paragraph (e), accounts receivable described in paragraphs (c) and (d) of this section are not taken into account. See paragraph (g) of this section for procedures to obtain automatic consent to change to one of the safe harbor nonaccrual experience methods or to an alternative nonaccrual-experience method.

(2) *Safe harbor 1: Six-year moving average method*—(i) *General rule*. A taxpayer may use a nonaccrual experience method under which the taxpayer determines the uncollectible amount (six-year moving average amount) by multiplying its accounts receivable balance at the end of the current year by a percentage (six-year moving average percentage). The six-year moving average percentage is computed by dividing—

(A) The total bad debts (with respect to accounts receivable) sustained throughout the period consisting of the taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period; by

(B) The sum of the accounts receivable earned throughout the entire six (or fewer) taxable year period (*i.e.*, the total amount of sales resulting in accounts receivable). See paragraph (f) *Example 4* of this section for an example of this method.

(ii) *Period of less than six taxable years*. A period shorter than six taxable years generally will be appropriate only if the short period consists of consecutive taxable years and there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. A decline in the general economic conditions in the area, which substantially increases the risk of loss, is a relevant factor in determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the accounts receivable outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to accounts receivable outstanding at the close of the six taxable years. A substantial increase in a taxpayer's bad debt experience is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall be made in accordance with the applicable procedures for requesting a letter ruling and shall include a statement of the reasons such experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) *Special rule for new taxpayers*. In the case of any current taxable year that is preceded by less than 5 taxable years, paragraph (e)(2)(i) of this section shall be applied by using the experience of the current year and the actual number of preceding taxable years.

(3) *Safe harbor 2: Actual experience method*—(i) *Option A: Three-year moving average*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount (actual nonaccrual-experience amount) by multiplying its year-end

accounts receivable balance by a percentage (three-year moving average nonaccrual-experience percentage) reflecting its actual nonaccrual experience with respect to its accounts receivable balance at the beginning of the current taxable year and the two immediately preceding taxable years. Under this safe harbor method, a taxpayer is allowed to increase its actual nonaccrual-experience amount by 5 percent (adjusted nonaccrual-experience amount). The taxpayer's three-year moving average nonaccrual-experience percentage, actual nonaccrual-experience amount, and adjusted nonaccrual-experience amount are determined according to the following steps:

(A) *STEP 1*. Track the receivables in the taxpayer's accounts receivable balance at the beginning of the current taxable year to determine the dollar amount of the accounts receivable actually determined to be uncollectible and charged off and not recovered or determined to be collectible by the date selected by the taxpayer (determination date) for the taxable year. The determination date may not be later than the earlier of the due date, including extensions, for filing the taxpayer's federal income tax return for that taxable year or the date on which the taxpayer timely files such return for that taxable year.

(B) *STEP 2*. Repeat STEP 1 for the taxpayer's accounts receivable balance at the beginning of each of the two immediately preceding taxable years.

(C) *STEP 3*. To determine the taxpayer's three-year moving average nonaccrual-experience percentage, divide the sum of the net uncollectible amounts from STEP 1 and STEP 2 by the sum of the accounts receivable balance at the beginning of the current taxable year and the accounts receivable balance at the beginning of each of the two preceding taxable years.

(D) *STEP 4*. Multiply the percentage computed in STEP 3 by the taxpayer's accounts receivable balance at the end of the current taxable year. The product is the taxpayer's actual nonaccrual-experience amount for the current taxable year.

(E) *STEP 5*. To determine the taxpayer's adjusted nonaccrual-experience amount, multiply the actual nonaccrual-experience amount from STEP 4 by 1.05. See paragraph (f) *Example 5* of this section for an example of this method.

(ii) *Option B: Up to three-year moving average*. Alternatively, except as provided in paragraph (e)(3)(iii) of this section, in computing its adjusted nonaccrual-experience amount described in paragraph (e)(3)(i) of this section, a taxpayer may use: its current year nonaccrual-experience percentage for the first taxable year this method is used; a two-year moving average nonaccrual-experience percentage for the second taxable year this method is used; and a three-year moving average nonaccrual-experience percentage for the third, and each succeeding, taxable year this method is used. See paragraph (f) *Examples 6*, *7*, and *8* of this section for examples of this method.

(iii) *Special rule for new taxpayers*. Any newly formed taxpayer that wants to use the safe harbor nonaccrual-experience method of accounting described in paragraph (e)(3)(ii) of this section in its first taxable year and does not have any accounts receivable upon formation will not be able to exclude any portion of its year-end accounts receivable from income for its first taxable year because the taxpayer does not have any accounts receivable on the first day of the taxable year to track. Therefore, the taxpayer must begin creating its three-year moving average in its second taxable year by tracking the accounts receivables as of the first day of its second taxable year.

(4) *Safe harbor 3: Modified Black Motor method*—(i) *In general*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount (modified Black Motor amount) by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (Black Motor moving average percentage), and then reducing the resulting amount by the credit charges (accounts receivable) generated and written off during the current taxable year. The Black Motor moving average percentage is computed by dividing—

(A) The total bad debts sustained in the current taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period; by

(B) The sum of accounts receivable at the end of the current taxable year and the five preceding (or fewer) taxable years. See paragraph (f) *Example 10* of this section for an example of this method.

(ii) *Period of less than six taxable years*. The rules of paragraph (e)(2)(ii) of this section (regarding periods of less than six taxable years) shall apply to taxpayers using the Modified Black Motor method.

(iii) *Special rules for new taxpayers*. In the case of any current taxable year that is preceded by less than 5 taxable years, paragraph (e)(4)(i) of this section shall be applied by using the experience of the current taxable year and the actual number of preceding taxable years.

(5) *Safe harbor 4: Modified six-year moving average method*—(i) *In general*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount (modified six-year moving average amount) by multiplying its accounts receivable balance at the end of the current year by a percentage (modified six-year moving average percentage). The modified six-year moving average percentage is computed by dividing—

(A) The total bad debts sustained in the current taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period) other than the credit charges (accounts receivable) that were written off in the same taxable year they were generated, adjusted for recoveries of bad debts during such period; by

(B) The sum of accounts receivable at the end of the current taxable year and the five preceding (or fewer) taxable years. See paragraph (f) *Example 11* of this section for an example of this method.

(ii) *Period of less than six taxable years.* The rules of paragraph (e)(2)(ii) of this section (regarding periods of less than six taxable years) shall apply to taxpayers using the Modified six-year moving average method.

(iii) *Special rules for new taxpayers*. In the case of any current taxable year that is preceded by less than 5 taxable years, paragraph (e)(5)(i) of this section shall be applied by using the experience of the current taxable year and the actual number of preceding taxable years.

(6) *Alternative nonaccrual-experience method*—(i) *In general*. A taxpayer may use any alternative nonaccrual-experience method that clearly reflects the taxpayer's actual nonaccrual-experience, provided

the taxpayer's alternative nonaccrual-experience method meets the self-test requirements described in this paragraph (e)(6).

(ii) *Self-testing*. A taxpayer using, or desiring to use, an alternative nonaccrual-experience method must "self-test" its alternative nonaccrual-experience method for its first taxable year ending after March 9, 2002, for which the taxpayer uses, or desires to use, that alternative nonaccrual-experience method (first-year self-test), and every three taxable years thereafter (three-year self-test). Each self-test shall be performed by comparing the nonaccrual-experience amount under the taxpayer's alternative nonaccrual-experience method (alternative nonaccrual-experience amount) with the nonaccrual-experience amount that would have resulted from use of one safe harbor method described in paragraph (e)(2), (e)(3), (e)(4), or (e)(5) of this section selected by the taxpayer for use in conducting the self test (safe harbor comparison method), for the test period.

(iii) *Selection of safe harbor comparison method*—(A) *First-year self-test*. For purposes of conducting the first-year self-test required under paragraph (e)(6)(ii) of this section, a taxpayer may self-test its alternative nonaccrual-experience method against any safe harbor method provided in paragraphs (e)(2) through (e)(5) of this section. See paragraph (f) *Example 12* of this section for an example of this rule.

(B) *Three-year self-test*. For purposes of conducting any three-year self-test required under paragraph (e)(6)(ii) of this section, the taxpayer must self-test its alternative nonaccrual-experience method against the same safe harbor comparison method used for the immediately preceding self-test. For purposes of the three-year self-test, the cumulative nonaccrual-experience amount for the safe harbor comparison method is computed by using, for each taxable year of the test period, the same safe harbor comparison method used during the immediately preceding self test (cumulative safe harbor nonaccrual-experience amount). See paragraph (f) *Example 13* of this section for an example of this rule.

(C) *Change of safe harbor comparison method*. (*1*) A taxpayer that wants to change the safe harbor comparison method it uses for purposes of the self-testing requirement of paragraph (e)(6)(ii) of this section may do so only for the first taxable year following any three-year self-test period and in accordance with this paragraph (e)(6)(iii)(C). A change in the taxpayer's safe harbor comparison method is a change in method of accounting to which the procedures of sections 446 and 481, and the regulations thereunder, apply.

(*2*) For the taxable year a taxpayer wishes to change its safe harbor comparison method, the taxpayer must self-test its alternative nonaccrual-experience method against any safe harbor method provided in paragraphs (e)(2) through (e)(5) of this section other than the safe harbor comparison method currently used by the taxpayer and such self-test shall be conducted as if such self-test was a first-year self-test.

(*3*) If the self-test described in paragraph (e)(6)(iii)(C)(*2*) of this section results in the taxpayer's alternative nonaccrual-experience method clearly reflecting the taxpayer's nonaccrual-experience as determined under paragraph (e)(6)(iv) of this section, then the taxpayer may change its safe harbor comparison method in accordance with the procedures under paragraph (g)(3) of this section. Such change shall be made on a cut-off basis and without audit protection.

(*4*) If the self-test described in paragraph (e)(6)(iii)(C)(*2*) of this section results in the taxpayer's alternative nonaccrual-experience method not clearly reflecting the taxpayer's nonaccrual-experience as determined under paragraph (e)(6)(vi)(A) of this section, then the taxpayer cannot use the safe harbor comparison method selected and must either—

(*i*) Continue using its current safe harbor comparison method; or

(*ii*) Select another safe harbor comparison method, subject to the requirements of paragraphs (e)(6)(iii)(C)(*2*) and (*3*) of this section.

(*5*) If a taxpayer meets the requirements of this paragraph (e)(6)(iii)(C) to change its safe harbor comparison method, the new safe harbor comparison method is not used for purposes of conducting the three-year self-test required by paragraph (e)(6)(ii) of this section for the taxable year immediately preceding the taxable year the taxpayer is permitted to change its safe harbor comparison method. The taxpayer's former safe harbor comparison method is used for purposes of conducting such three-year self-test and for purposes of determining any recapture amount under paragraph (e)(6)(vi)(B) of this section.

(iv) *Treated as clearly reflecting nonaccrual-experience*. If the alternative nonaccrual-experience amount for the first-year self-test (or the cumulative nonaccrual-experience amount for the three-year self-test, as applicable) is less than or equal to the nonaccrual-experience amount determined under paragraph (e)(6)(iii)(A) of this section (first-year self-test) or the cumulative safe harbor nonaccrual-experience amount determined under paragraph (e)(6)(iii)(B) of this section (three-year self-test), as applicable, of this section for the test period, then—

(A) The taxpayer's alternative nonaccrual-experience method will be treated as clearly reflecting its nonaccrual-experience for the test period; and

(B) The taxpayer may continue to use that alternative nonaccrual-experience method, subject to a requirement to self-test again after three taxable years.

(v) *Contemporaneous documentation*. For purposes of paragraph (e)(6) of this section, a taxpayer must document in its books and records, in the taxable year any first-year or three-year self-test is performed, the safe harbor comparison method used to conduct the self-test, including appropriate documentation and computations that resulted in the determination that the taxpayer's alternative nonaccrual-experience method clearly reflected the taxpayer's nonaccrual-experience for the applicable test period.

(vi) *Special rules for alternative nonaccrual-experience method*. (A) *First-year self-test*. If, as a result of the first-year self-test requirement of paragraph (e)(6)(ii) of this section, the alternative nonaccrual-experience amount for the test period is greater than the safe harbor nonaccrual-experience amount for the test period, then—

(*1*) The taxpayer's alternative nonaccrual-experience method will be treated as not clearly reflecting its nonaccrual-experience;

(*2*) The taxpayer will not be permitted to use that alternative nonaccrual-experience method in such taxable year; and

(*3*) The taxpayer must change to (or adopt) for such taxable year either—

(*i*) A safe harbor nonaccrual-experience method described in paragraphs (e)(2) through (e)(5) of this section; or

(*ii*) Another alternative nonaccrual-experience method, subject to the first-year self-test requirement of paragraph (e)(6)(ii) of this section. See paragraph (f) *Example 14* of this section for an example of this rule.

(B) *Three-year self-test*. If, as a result of the three-year self-test requirement of paragraph (e)(6)(ii) of this section, the cumulative alternative nonaccrual-experience amount for the test period is greater than the cumulative safe harbor nonaccrual-experience amount for the test period, the taxpayer's alternative nonaccrual-experience amount will be limited to the cumulative safe harbor nonaccrual-experience amount for the test period. Any excess of the taxpayer's cumulative alternative nonaccrual-experience amount over the taxpayer's cumulative safe harbor nonaccrual-experience amount excluded from income during the test period must be recaptured into income in accordance with paragraph (e)(6)(vii) of this section. The taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement in paragraph (e)(6)(ii) of this section. See paragraph (f) *Example 15* of this section for an example of this rule.

(vii) *Recapture*—(1) *In general*. Any amount required to be recaptured pursuant to paragraph (e)(6)(vi)(B) of this section must be included in income in the third taxable year of the three-year self-test period. See paragraph (f) *Example 15* of this section for an example of this rule.

(7) *Special rules*—(i) *Application to specific accounts receivable*. The nonaccrual-experience method shall be applied with respect to each account receivable of the taxpayer that is eligible for such method. With respect to a particular account receivable, the taxpayer will determine, in the manner prescribed in paragraphs (e)(2) through (e)(6) of this section (whichever applies), the amount of such account receivable that is not expected to be collected. Such determination shall be made only once with respect to each account receivable, regardless of the term of such receivable. The estimated uncollectible amount shall not be recognized as gross income. Thus, the amount recognized as gross income shall be the amount that would otherwise be recognized as gross income with respect to the account receivable, less the amount which is not expected to be collected. A taxpayer that excludes an amount from income during a taxable year as a result of the taxpayer's use of a nonaccrual-experience method cannot deduct in any subsequent taxable year the amount excluded from income. Thus, the taxpayer cannot deduct the excluded amount in a subsequent taxable year in which the taxpayer actually determines that the amount is uncollectible and charges it off. If a taxpayer using a nonaccrual-experience method determines that an amount that was not excluded from income is uncollectible and should be charged off (*e.g.*, a calendar-year taxpayer determines on November 1st that an account receivable that was originated on May 1st of the same year is uncollectible and should be charged off) the taxpayer may deduct the amount charged off when it is charged off, but must include any subsequent recoveries in income. The reasonableness of a taxpayer's determinations that amounts are uncollectible and should be charged off may be considered on examination. See paragraph (f) *Example 16* of this section for an example of this rule.

(ii) *Charge-off*. For purposes of this section, amounts charged-off shall include only those amounts that would otherwise be allowable under section 166(a).

(iii) *Recoveries*. Regardless of the nonaccrual-experience method of accounting used by a taxpayer under this section, the taxpayer must take into account recoveries of amounts previously charged off. If, in a subsequent taxable year, a taxpayer recovers an amount previously excluded from income under a nonaccrual-experience method or charged off, the taxpayer must include the recovered amount in income in that subsequent taxable year. See paragraph (f) *Example 17* of this section for an example of this rule.

(iv) *Application of nonaccrual-experience method*. The rules of section 448(d)(5) and the regulations thereunder shall be applied separately to each taxpayer. For purposes of section 448(d)(5), the term "taxpayer" has the same meaning as the term "person" defined in section 7701(a)(1) (rather than the meaning of the term "taxpayer" defined in section 7701(a)(14)).

(v) *Record keeping requirements*. (A) A taxpayer using a nonaccrual-experience method shall keep such books and records as are sufficient to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year, including books and records demonstrating—

(*1*) The nature of the taxpayer's nonaccrual-experience method;

(*2*) Whether, for any particular taxable year, the taxpayer qualifies to use its nonaccrual-experience method (including the self-testing requirements of paragraph (e)(6)(ii) of this section (if applicable));

(*3*) The taxpayer's determination that amounts are uncollectible; and

(*4*) The proper amount that is excludable under the taxpayer's nonaccrual-experience method.

(B) A taxpayer that does not maintain records of the data that are sufficient to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year may be subject to being changed by the IRS on examination to the specific charge-off method. See §1.6001–1 for rules regarding records.

(f) *Examples*. The following examples illustrate the provisions of this section. In each example, the taxpayer uses a calendar year for federal income tax purposes and an accrual method of accounting, does not require the payment of interest or penalties with respect to past due accounts receivable (except in the case of *Example 1*) and, in the case of *Examples 5* through *8* and *12* through *15*, selects an appropriate determination date for each taxable year.

Example 1. Charging interest and/or penalties. A has two billing methods for the amounts to be received from A's provision of services described in paragraph (a)(1) of this section. Under one method, for amounts that are more than 90 days past due, A charges interest at a market rate until such amounts (together with interest) are paid. Under the other billing method, A charges no interest for amounts past due. Pursuant to paragraph (c) of this section, A may not use a nonaccrual-experience method of accounting with respect to any of the amounts billed under the method that charges interest on amounts that are more than 90 days past due. A may, however, use the nonaccrual-experience method with respect to the amounts billed under the method that does not charge interest for amounts past due.

Example 2. Contractual allowance or adjustment. B, a healthcare provider, performs a medical procedure on individual C, who has health insurance coverage with IC, an insurance company. B bills IC and C for $5,000, B's standard charge for this medical procedure. However, B has a contract with IC that obligates B to accept $3,500 as full payment for the medical procedure if the procedure is provided to a patient insured by IC. Under the contract, only $3,500 of the $5,000 billed by B is legally collectible from IC and C. The remaining $1,500 represents a contractual allowance or contractual adjustment. Thus, pursuant to paragraph (d)(2) of this section, the remaining $1,500 is not a contractually collectible amount for purposes of this section and B may not use a nonaccrual-experience method with respect to this portion of the accounts receivable.

Example 3. Charitable or pro bono services. D, a law firm, agrees to represent individual E in a legal matter and to provide services to E on a *pro bono* basis. D normally charges $500 for these services. Because D performed its services to E *pro bono*, D's services were never billed or intended to result in revenue. Thus, pursuant to paragraph (d)(2) of this section, the $500 forgone legal fee is not a collectible amount for purposes of this section and D may not use a nonaccrual-experience method with respect to this portion of the accounts receivable.

Example 4. Safe harbor 1: Six-year moving average method. (i) F uses the six-year moving average method described in paragraph (e)(2) of this section. F's total accounts receivable and bad debt experience for the current taxable year (2002) and the five preceding taxable years are as follows:

Taxable Year	*Total Accounts Receivable*	*Bad Debts Adjusted for Recoveries*
1997	$30,000	$5,700
1998	40,000	7,200
1999	40,000	11,000
2000	60,000	10,200
2001	70,000	14,000
2002	90,000	16,800
Total	$330,000	$64,900

(ii) Thus, F's six-year moving average percentage is 19.67% ($64,900/$330,000). Assume that $49,300 of the total $90,000 of accounts receivable earned throughout the taxable year 2002 is outstanding as of the close of that taxable year. F's nonaccrual-experience amount using the six-year moving average safe harbor method is computed by multiplying $49,300 by the six-year moving average percentage of .1967, or $9,697. Thus, F may exclude $9,697 from gross income for 2002.

Example 5. Safe harbor 2: Actual experience method (Option A). (i) G is eligible to use a nonaccrual-experience method and wishes to adopt the actual experience method of paragraph (e)(3)(i) of this section. G has the data necessary to track the uncollectible amounts in its beginning-of-year accounts receivable for the current taxable year and the two immediately preceding taxable years. G determines that its actual accounts receivable collection experience is as follows:

Taxable Year	*Total A/R Balance At Beginning of Year*	*Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)*
2000	$1,000,000	$35,000
2001	760,000	75,000
2002	1,975,000	65,000
Total	$3,735,000	$175,000

(ii) G's ending A/R Balance on 12/31/2002, is $880,000. In 2002, G chooses to compute its nonaccrual-experience amount by using the three-year moving average under Option A of paragraph (e)(3)(i) of this section. Thus, G's three-year moving average nonaccrual-experience percentage is 4.7%, determined by dividing the sum of the amount of G's receivables in its account on January 1st of 2000, 2001, and 2002, that were determined to be uncollectible and charged off (adjusted for recoveries) on or before the corresponding determination dates, by the sum of the balances of G's accounts receivable account on January 1st of 2000, 2001, and 2002 (*i.e.*, $175,000/$3,735,000 or 4.7%). Thus, G's actual nonaccrual-experience amount for 2002 is determined by multiplying this percentage by the balance of G's accounts receivable account on December 31, 2002 (*i.e.*, $880,000 x 4.7% = $41,360). G is permitted to exclude from gross income in 2002 an amount equal to 105% of G's actual nonaccrual-experience amount, or $43,428 ($41,360 x 105%). This is G's adjusted nonaccrual-experience amount for 2002.

Example 6. Safe harbor 2: Actual experience method (Option B). The facts are the same as *Example 5*, except that G has not maintained the data necessary to use Option A of paragraph (e)(3)(i) of this section. G determines that, of its 2002 beginning-of-year receivables of $1,975,000, $65,000 were determined to be uncollectible and charged off (adjusted for recoveries) on or before September 15, 2003, the date G timely files its federal income tax return for 2002 (the determination date). G chooses to use Option B of paragraph (e)(3)(ii) of this section to compute its adjusted nonaccrual-experience amount for 2002. G's current year nonaccrual-experience percentage is 3.3%, determined by dividing the amount of G's receivables in its account on January 1, 2002, that were charged off as uncollectible (adjusted for recoveries) on or before the determination date, by the balance of G's accounts receivable account on January 1, 2002 (*i.e.*, $65,000/$1,975,000 or 3.3%). Thus, G's actual nonaccrual-experience amount for 2002 is determined by multiplying this percentage by the balance of G's accounts receivable account on December 31, 2002 (*i.e.*, $880,000 x 3.3% = $29,040). G is permitted to exclude from gross income in 2002 an amount equal to 105% of G's actual nonaccrual-experience amount, or $30,492 ($29,040 x 105%). This is G's adjusted nonaccrual-experience amount for 2002.

Example 7. (i) The facts are the same as *Example 6*. G determines that its accounts receivable collection experience for 2003 is as follows:

Taxable Year	*Total A/R Balance At Beginning of Year*	*Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)*
2002	$1,975,000	$65,000
2003	880,000	95,000
Total	$2,855,000	$160,000

(ii) G's ending A/R Balance on 12/31/2003, is $2,115,000. In 2003, G must compute its nonaccrual-experience amount using an average of its actual nonaccrual-experience for 2002 and 2003 (in accordance with Option B of paragraph (e)(3)(ii) of this section). Thus, G's two-year moving average nonaccrual-experience percentage is 5.6%, determined by dividing the sum of the amount of G's receivables in its accounts on January 1st of 2002 and 2003, that were determined to be uncollectible and charged off (adjusted for recoveries) on or before the corresponding determination dates, by the sum of the balances of G's accounts receivable account on January 1st of 2002 and 2003 (*i.e.*, $160,000/$2,855,000 or 5.6%). Thus, G's actual nonaccrual-experience amount for 2003 is determined by multiplying this percentage by the balance of G's accounts receivable account on December 31, 2003 (*i.e.*, $2,115,000 x 5.6% = $118,440). G is permitted to exclude from gross income in 2003 an amount equal to 105% of G's actual nonaccrual-experience amount, or $124,362 ($118,440 x 105%). This is G's adjusted nonaccrual-experience amount for 2003.

Example 8. (i) The facts are the same as *Example 7*. G determines that its accounts receivable collection experience for 2004 is as follows:

Taxable Year	*Total A/R Balance At Beginning of Year*	*Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)*
2002	$1,975,000	$65,000
2003	880,000	95,000
2004	2,115,000	105,000
Total	$4,970,000	$265,000

(ii) G's ending A/R Balance on 12/31/2004, is $1,600,000. In 2004, G must compute its nonaccrual-experience amount using an average of its actual nonaccrual-experience for 2002, 2003, and 2004 (in accordance with Option B of paragraph (e)(3)(ii) of this section). Thus, G's actual three-year moving average nonaccrual-experience percentage is 5.3%, determined by dividing the sum of the amount of G's receivables in its account on January 1st of 2002, 2003, and 2004, that were determined to be uncollectible and charged off (adjusted for recoveries) on or before the corresponding determination dates, by the sum of the balances of G's accounts receivable account on January 1st of 2002, 2003, and 2004 (*i.e.*, $265,000/$4,970,000 or 5.3%). Thus, G's actual nonaccrual-experience amount for 2004 is determined by multiplying this percentage by the balance of G's accounts receivable account on December 31, 2004 (*i.e.*, $1,600,000 x 5.3% = $84,800). G is permitted to exclude from gross income in 2004 an amount equal to 105% of G's actual nonaccrual-experience amount, or $89,040 ($84,800 x 105%). This is G's adjusted nonaccrual-experience amount for 2004. Thereafter, G must continue to use a three-year moving average to compute its actual nonaccrual-experience, or obtain approval of the Commissioner to change its nonaccrual-experience method of accounting.

Example 9. H has not tracked its 2002 beginning-of-year accounts receivable. Therefore, H may not use the actual experience method described in paragraph (e)(3) of this section for 2002. H may use this method for 2003 if H tracks its 2003 beginning-of-year receivables, and otherwise complies with the requirements of this section.

Example 10. *Safe harbor 3: Modified Black Motor method*. (i) J uses the modified Black Motor method described in paragraph (e)(4) of this section. J's total accounts receivable and bad debt experience for the current taxable year (2002) and the five preceding taxable years are as follows:

Taxable Year	Accounts Receivable At End of Taxable Year	Bad Debts (adjusted for recoveries)
1997	$130,000	$9,100
1998	140,000	7,000
1999	140,000	14,000
2000	160,000	14,400
2001	170,000	20,400
2002	180,000	10,800
Total	$920,000	$75,700

(ii) Thus, J's Black Motor moving average percentage is 8.228% ($75,700/$920,000). Assume that the credit charges (accounts receivable) generated and written off during the current taxable year were $3,600. J's modified Black Motor amount is $11,210, computed by multiplying J's accounts receivable at December 31, 2002 ($180,000) by the Black Motor moving average percentage of .08228 and reducing the resulting amount by $3,600 (J's credit charges (accounts receivable) generated and written off during the 2002 taxable year). Thus, J may exclude $11,210 from gross income for 2002.

Example 11. Safe harbor 4: Modified six-year moving average method. (i) The facts are the same as *Example 10*, except that J uses the modified six-year moving average method described in paragraph (e)(5) of this section. Assume further that the credit charges (accounts receivable) that were written off in the same taxable year they were generated, adjusted for recoveries of bad debts during such period are as follows:

Taxable Year	Credit Charges Written Off In Same Taxable Year as Generated (adjusted for recoveries)
1997	$3,033
1998	2,333
1999	4,667
2000	4,800
2001	6,800
2002	3,600
Total	$25,223

(ii) Thus, J's modified six-year moving average percentage is 5.486% (($75,700 - $25,233)/$920,000). J's modified six-year moving average amount is $9,875, computed by multiplying J's accounts receivable at December 31, 2002 ($180,000), by the modified six-year moving average percentage of .05486. Thus, J may exclude $9,875 from gross income for 2002.

Example 12. Selection of a safe harbor comparison method. (i) Beginning in 2002, K is eligible to use a nonaccrual-experience method and wishes to adopt an alternative nonaccrual-experience method similar to the method described in Black Motor Co. v. Comm'r, 41 B.T.A. 300 (1940), aff'd, 125 F.2d 977 (6th Cir. 1942). Pursuant to paragraph (e)(6)(ii) of this section, K must self-test its alternative nonaccrual-experience method for the first taxable year it is used (2002), and every three taxable years thereafter for which K uses its alternative nonaccrual-experience method. Pursuant to paragraph (e)(6)(iii) of this section, K selects safe harbor 2 (actual experience method) for purposes of conducting its first-year self-test. Thus, beginning in 2002, K must begin tracking its beginning-of-year accounts receivable and computing its actual nonaccrual-experience as provided in paragraph (e)(3) of this section. However, because K lacks the data to use Option A (three-year moving average) under paragraph (e)(3)(i) of this section, K selects Option B (up to three-year moving average) under paragraph (e)(3)(ii) of this section. K's actual nonaccrual-experience amount and alternative nonaccrual-experience amount for 2002 are set forth below:

Taxable Year	Total A/R Balance At Beginning of Year	Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)	Alternative Nonaccrual-Experience Amount
2002	$350,000	$14,000	$20,700

(ii) K's ending A/R Balance on 12/31/2002, is $500,000. K's actual nonaccrual-experience percentage is 4%, determined by dividing the amount of K's receivables in its account on January 1, 2002, that were charged off as uncollectible (adjusted for recoveries) on or before the determination date, by the balance of K's accounts receivable account on January 1, 2002 (*i.e.,* $14,000/$350,000 or 4%). Thus, K's actual nonaccrual-experience amount for 2002 is determined by multiplying this percentage by the balance of K's accounts receivable account on December 31, 2002 (*i.e.*, $500,000 x 4% = $20,000). Because K's alternative nonaccrual-experience amount for 2002 ($20,700) is not greater than 105% of its actual nonaccrual-experience amount for 2002 (*i.e.*, $20,000 x 1.05 = $21,000), pursuant to paragraph (e)(6)(iv) of this section, K's alternative nonaccrual-experience method will be treated as clearly reflecting its nonaccrual-experience for the test period 2002. Pursuant to paragraph (e)(6)(iv)(B) of this section, K may continue to use its alternative nonaccrual-experience method. Additionally, pursuant to paragraph (e)(6)(iv)(B) of this section, K is required to self-test its alternative nonaccrual-experience method again in 2006, for taxable years 2003 through 2005 and, pursuant to paragraph (e)(6)(iii)(B) of this section, K must self-test its alternative nonaccrual-experience method against the actual experience method when conducting its three year self-test in 2006.

Example 13. (i) The facts are the same as *Example 12*. K's alternative nonaccrual-experience amounts for taxable years 2003–2005 are as follows:

Taxable Year	*Total A/R Balance At Beginning of Year*	*Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)*	*Actual Nonaccrual-Experience Amount*	*Alternative Nonaccrual-Experience Amount*
2003	$440,000	$30,000	$42,329	$43,050
2004	760,000	65,000	138,183	140,200
2005	1,965,000	65,000	101,106	110,550
Total	$3,165,000	$160,000	$281,618	$293,800

(ii) Assume that K's ending A/R balance on 12/31/05, is $2,000,000. Because K's cumulative alternative nonaccrual-experience amount for the test period ($293,800) is not greater than K's cumulative adjusted nonaccrual-experience amount (cumulative actual nonaccrual-experience amount x 105%) for the same period ($281,618 x 1.05 = $295,699), pursuant to paragraph (e)(6)(iv) of this section K's alternative nonaccrual-experience method will be treated as clearly reflecting its nonaccrual-experience for the test period. Pursuant to paragraph (e)(6)(iv)(B) of this section, K may continue to use its alternative nonaccrual-experience method. Additionally, pursuant to paragraph (e)(6)(iv)(B) of this section, K is required to self-test its alternative nonaccrual-experience method again in 2009, for taxable years 2006 through 2008 and, pursuant to paragraph (e)(6)(iii)(B) of this section, K must self-test its alternative nonaccrual-experience method against the actual experience method when conducting its three-year self-test in 2009.

Example 14. The facts are the same as *Example 12*, except that K's alternative nonaccrual-experience amount for 2002 is $22,000. Because K's alternative nonaccrual-experience amount for 2002 ($22,000) is greater than 105% of its actual nonaccrual-experience amount for 2002 (*i.e.,* $20,000 x 1.05 = $21,000), pursuant to paragraph (e)(6)(vi)(A) of this section, K's alternative nonaccrual-experience method will be treated as not clearly reflecting its nonaccrual experience for 2002. Accordingly, K must either adopt a safe harbor nonaccrual-experience method described in paragraphs (e)(2) (six-year moving average method), (e)(3) (actual experience method), (e)(4) (modified Black Motor method), or (e)(5) (modified six-year moving average method) of this section, or an alternative nonaccrual-experience method under paragraph (e)(6) of this section (subject to the self-testing requirements of paragraph (e)(6)(ii) of this section).

Example 15. The facts are the same as *Example 13*, except that K's cumulative alternative nonaccrual-experience amount for 2003–2005 is $300,000. Because K's cumulative alternative nonaccrual-experience amount for the three-year test period (taxable years 2003–2005) is greater than its cumulative adjusted nonaccrual-experience amount for the three-year test period ($295,699), pursuant to paragraph (e)(6)(vi)(B) of this section the $4,301 excess of K's cumulative alternative nonaccrual-experience amount over K's cumulative adjusted nonaccrual-experience amount for the three-year test period must be recaptured into income in 2005 in accordance with paragraph (e)(6)(vii) of this section. K may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement in paragraph (e)(6)(ii) of this section.

Example 16. *Subsequent worthlessness of year-end receivable*. The facts are the same as *Example 4*. Assume that one of the accounts receivable outstanding at the end of 2002 was for $8,000, and that in 2003, under section 166, the entire amount of this receivable becomes wholly worthless. Because F did not accrue as income $1,573 of this account receivable ($8,000 x .1967) under the nonaccrual-experience method in 2002, pursuant to paragraph (e)(7)(i) of this section F may not deduct this portion of the account receivable as a bad debt deduction under section 166 in 2003. F may deduct the remaining balance of the receivable in 2003 as a bad debt deduction under section 166 ($8,000 - $1,574 = $6,426).

Example 17. *Subsequent collection of year-end receivable*. The facts are the same as in *Example 4*. Assume that an account receivable of $1,700 outstanding at the end of 2002 was collected in full by F in 2003. Pursuant to paragraph (e)(7)(iii) of this section, F must recognize additional gross income in 2003 equal to the portion of this receivable that F excluded from gross income in the prior year ($1,700 x .1967 = $334).

(g) *Changes to a nonaccrual-experience method of accounting*—(1) *In general*. A change to a nonaccrual-experience method is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder, apply.

(2) *Taxpayers no longer qualified under section 448 to use a nonaccrual-experience method*—(i) *First taxable year ending after March 9, 2002*. For a taxpayer who no longer qualifies under section 448(d)(5), as amended, to use a nonaccrual-experience method, consent is hereby granted to change from the nonaccrual-experience method to the specific charge-off method for its first taxable year ending after March 9, 2002. Such change shall be made in accordance with the provisions of this paragraph (g)(2). Pursuant to the consent granted by this paragraph (g)(2), a taxpayer described in this paragraph (g)(2) that is using a nonaccrual experience method must change such method of accounting to the specific charge-off method for its first taxable year ending after March 9, 2002. The net amount of the required section 481(a) adjustment is to be taken into account

over a period of 4 taxable years (or, if less, the number of taxable years that the taxpayer has used the nonaccrual-experience method). The taxpayer should attach Form 3115 to its income tax return for the year of change, and write "Change from the Nonaccrual-Experience Method under §1.448–2T(g)" at the top of the form. However, such a taxpayer is not required to file a Form 3115 with the national office, or pay any associated user fee.

(ii) *For taxable years subsequent to first taxable year ending after March 9, 2002*. Taxpayers who no longer qualify under section 448(d)(5), as amended, to use a nonaccrual-experience method in a taxable year subsequent to the first taxable year ending after March 9, 2002, must follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method. (For further guidance, for example, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(*b*) of this chapter.)

(3) *Taxpayers permitted to use a nonaccrual-experience method*—(i) *In general*. Except as provided in paragraphs (g)(3)(ii) (regarding scope limitations) and (g)(4) (regarding certain concurrent changes) of this section, a taxpayer that wants to change to a nonaccrual-experience method provided in this section, change from one nonaccrual-experience method to another nonaccrual-experience method provided in this section, and/or change to a periodic system (for further guidance, for example, see Notice 88–51, 1988–1 C.B. 535, and §601.601(d)(2)(ii)(*b*) of this chapter) must follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Scope limitations*. Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer that wants to change to a nonaccrual-experience method of accounting provided in this section, and/or change to a periodic system (for further guidance, for example, see Notice 88–51, 1988–1 C.B. 535, and §601.601(d)(2)(ii)(*b*) of this chapter), for either its first or second taxable year ending after March 9, 2002, provided the taxpayer's nonaccrual-experience method of accounting is not an issue under consideration for taxable years under examination at the time the Form 3115 is filed with the national office. A taxpayer's nonaccrual-experience method of accounting is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the treatment of the nonaccrual-experience method of accounting as an issue under consideration.

(iii) *Form 3115 must be completed*. When filing the Form 3115, the taxpayer must complete all applicable parts of the form and write "Automatic Change to Nonaccrual-Experience Method" at the top of the form.

(4) *Certain concurrent changes*—(i) *Taxpayers concurrently changing to an accrual method of accounting*—(A) *Automatic consent*. Taxpayers that want to change to a nonaccrual-experience method of accounting for the same taxable year for which they are required to change to an accrual method of accounting under section 448 and the regulations thereunder may concurrently change their method of accounting to a nonaccrual-experience method (with or without also changing to a periodic system (for further guidance, for example, see Notice 88–51, 1988–1 C.B. 535, and §601.601(d)(2)(ii)(*b*) of this chapter)), under this paragraph (g)(4)(i) with automatic consent of the Commissioner if they otherwise qualify under this section to use a nonaccrual-experience method of accounting. Taxpayers changing to a nonaccrual-experience method under this paragraph (g)(4)(i) must comply with the provisions of §1.448–1(h)(2). Moreover, such taxpayers must type or legibly print the following statement at the top of page 1 of Form 3115, "*Automatic Change to Nonaccrual-Experience Method and Overall Accrual Method*." The consent of the Commissioner to change to a nonaccrual-experience method is granted to taxpayers changing to such method under this paragraph (g)(4)(i).

(B) *Section 481(a) adjustment*. In the case of a taxpayer changing to a nonaccrual-experience method under this paragraph (g)(4)(i), the section 481(a) adjustment resulting from the change to a nonaccrual-experience method of accounting will be combined or netted with the net section 481(a) adjustment resulting from the change under §1.448–1(h)(2), and the resulting net section 481(a) adjustment will be taken into account over the section 481(a) adjustment period as determined under the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method.

(ii) *Taxpayers concurrently changing to a permissible special method*—(A) *Prior consent*. A taxpayer required to change to an accrual method of accounting under section 448 and the regulations thereunder that, as part of such change, also wants to change to a nonaccrual experience method of accounting and a permissible special method of accounting under §1.448–1(h)(3), may concurrently change its method of accounting to a nonaccrual-experience method of accounting (with or without also changing to a periodic system (for further guidance, for example, see Notice 88–51, 1988–1 C.B. 535, and §601.601(d)(2)(ii)(*b*) of this chapter)), under this paragraph (g)(4)(ii) with the prior consent of the Commissioner if the taxpayer otherwise qualifies under this section to use a nonaccrual-experience method of accounting. Taxpayers changing to a nonaccrual-experience method under this paragraph (g)(4)(ii) must comply with the provisions of §1.448–1(h)(3). Moreover, such taxpayers must type or legibly print the following statement at the top of page 1 of Form 3115, "*Change to Nonaccrual-Experience Method and Special Method of Accounting—Section 448*."

(B) *Section 481(a) adjustment*. The section 481(a) adjustment resulting from a change in method of accounting described under this paragraph (g)(4)(ii) must be taken into account in accordance with the rules provided in paragraph (g)(4)(i)(B) of this section.

(h) *Transition rules*—(1) *In general*. If a taxpayer adopted or changed to a nonaccrual-experience method of accounting in accordance with the provisions of Notice 2003–12 for any taxable year ending after March 9, 2002, and, on or before October 20, 2003, and for such taxable year the taxpayer would like to change to a different nonaccrual-experience method of accounting as provided in paragraphs (e)(2) through (e)(6) of this section, and/or change to a periodic system (for further guidance, for example, see Notice 88–51, 1988–1 C.B. 535, and §601.601(d)(2)(ii)(*b*) of this chapter), the taxpayer must follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and § 601.601(d)(2)(ii)(*b*) of this chapter) and must file the original Form 3115 either—

(i) With an amended federal income tax return (or a qualified amended return under Rev. Proc. 94–69, 1994–2 C.B. 804, if applicable; hereinafter, referred to in this section as a "qualified amended return") on or before December 31, 2003, for the taxpayer's first taxable year ending after March 9, 2002, and any affected subsequent taxable year, and include the statement "Filed Pursuant to §1.448–2T(h)(1)(i)" at the top of any amended federal income tax return (or qualified amended return);

(ii) With the taxpayer's timely filed federal income tax return for the second taxable year ending after March 9, 2002, if this return has not been filed on or before September 4, 2003; or

(iii) If the taxpayer's federal income tax return for the second taxable year ending after March 9, 2002, was filed on or before September 4, 2003, with an amended federal income tax return (or a qualified amended return) on or before December 31, 2003, for the second taxable year ending after March 9, 2002, and include the statement "Filed Pursuant to §1.448–2T(h)(1)(iii)" at the top of the amended federal income tax return (or qualified amended return).

(2) *Pending Form 3115*. If a taxpayer filed a Form 3115 under the applicable administrative procedures with the national office to make a change in its method of accounting under section 448(d)(5), as amended, for a year of change for which this regulation is effective and the application or ruling request is pending with the national office on September 4, 2003, the taxpayer must notify the national office in writing prior to November 3, 2003, if the taxpayer wants to withdraw its Form 3115 under such administrative procedures. If the taxpayer notifies the national office within the time provided in this paragraph (h)(2), the taxpayer's Form 3115, and any user fee that was submitted with the Form 3115, will be returned to the taxpayer. A taxpayer whose Form 3115 is returned under this paragraph (h)(2) may file a new Form 3115 under the provisions prescribed in paragraphs (g) and (h) of this section. If the taxpayer does not notify the national office within the time provided in this paragraph (h)(2), the national office will continue to process the taxpayer's Form 3115 in accordance with the administrative procedures under which it was originally filed.

(i) [Reserved]

(j) *Audit protection*. If a taxpayer uses one of the nonaccrual-experience methods of accounting described in paragraphs (e)(3) (actual experience method), (e)(4) (modified Black Motor method), or (e)(5) (modified six-year moving average method) of this section to determine its amount excluded from gross income under section 448(d)(5), as amended, the taxpayer's use of that method will not be raised as an issue by the IRS in a taxable year that ends before September 4, 2003. If the taxpayer uses one of the nonaccrual-experience methods of accounting described in paragraphs (e)(3), (e)(4), or (e)(5) of this section, and its use of such method is an issue under consideration in examination (as defined in paragraph (g)(3)(ii) of this section), in appeals, or before the U.S. Tax Court in a taxable year that ends before September 4, 2003, that issue will not be further pursued by the IRS.

(k) *Effective date.* This section is applicable for taxable years ending after March 9, 2002. The applicability of this section expires on or before September 3, 2006.

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) ***

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.448–2T	1545–1855
* * * * *	

Judith B. Tomaso,
Acting Deputy Commissioner for Services and Enforcement.

Approved August 28, 2003.

Gregory F. Jenner,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 3, 2003, 8:45 a.m., and published in the issue of the Federal Register for September 4, 2003, 68 F.R. 52496)

Section 1016.—Adjustments to Basis

26 CFR 1.1016–3: Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

Rules are provided for reduction of basis for business use of an automobile under either the optional standard mileage rate method or a mileage allowance under a reimbursement or other expense allowance arrangement. See Rev. Proc. 2003-76, page 924.

Section 1502.—Regulations

26 CFR 1.1502–19: Excess loss accounts.

T.D. 9089

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations under section 1502 that govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. These temporary regulations affect corporations filing consolidated returns. The text of the temporary regulations also serves as the text of the proposed regulations (REG–132760–03) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective August 29, 2003.

FOR FURTHER INFORMATION CONTACT: Amber Renee Cook or Marie C. Milnes-Vasquez at (202) 622–7530 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 61(a)(12) of the Internal Revenue Code provides that gross income includes income from the discharge of indebtedness, except as provided by law. Section 108(a) provides that gross income of a C corporation does not include any amount that would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer if the discharge occurs in a title 11 case (section 108(a)(1)(A)), the discharge occurs when the taxpayer is insolvent, but only to the extent of the insolvency (section 108(a)(1)(B)), or the indebtedness discharged is qualified farm indebtedness (section 108(a)(1)(C)).

Although section 108 does not require certain taxpayers to include discharge of indebtedness income in gross income, it does require the reduction of tax attributes. Section 108(b)(1) provides that if a taxpayer excludes an amount from gross income under section 108(a)(1)(A), (B), or (C), the taxpayer must reduce its tax attributes by the amount excluded. Absent an election under section 108(b)(5) (described below), pursuant to section 108(b)(2), tax attributes are reduced in the following order: net operating losses and net operating loss carryovers, general business credits under section 38, minimum tax credits under section 53(b), net capital losses and capital loss carryovers, asset basis, passive activity loss and credit carryovers under section 469(b), and foreign tax credits and foreign tax credit carryovers. Section 108(b)(5) provides that the taxpayer may elect to apply any portion of excluded discharge of indebtedness income to first reduce basis in depreciable assets under the rules of section 1017. Any amount of debt discharge that remains after attribute reduction is not includible in income. See H.R. Rep. 96–833 at 11 (1980); S. Rep. No. 96–1035 at 12 (1980).

These provisions are designed to "preserve the debtor's 'fresh start' after bankruptcy." H.R. Rep. 96–833 at 9 (1980); see S. Rep. No. 96–1035 at 10 (1980). In addition, they are intended to "carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge." H.R. Rep. 96–833 at 9 (1980); see S. Rep. No. 96–1035 at 10 (1980). By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.

Questions have arisen regarding the application of section 108 when the taxpayer with discharge of indebtedness income that is excluded from gross income is a member of a consolidated group. In particular, questions have arisen regarding the determination of the attributes that are available for reduction in a consolidated group and the method for reducing those attributes. These regulations provide guidance regarding those questions.

Explanation of Provisions

A. *Application of Section 108(a)(1)(B)*

As described above, pursuant to section 108(a)(1)(B), gross income of an insolvent C corporation does not include any amount that would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer, but only to the extent of the insolvency. The IRS and Treasury believe that computing the amount of the insolvency for purposes of section 108(a)(1)(B) with respect to only the debtor member reflects that, without an agreement that provides otherwise, the assets of members other than the debtor member will not be available to satisfy claims of the creditors of the debtor member. Therefore, these temporary regulations provide that the amount of discharge of indebtedness income excluded from gross income in the case in which the debtor is insolvent is determined based on the assets and liabilities of only the member with discharge of indebtedness income.

B. *Application of Section 108(b)*

1. *Consolidated approach*

The IRS and Treasury Department have considered a separate entity approach and various consolidated approaches to the application of the attribute reduction rules of section 108(b) in the consolidated group context. As explained below, these regulations adopt a consolidated approach that reduces all attributes that are available to the debtor.

The IRS and Treasury Department have rejected a separate entity approach. Such an approach would reduce only the attributes attributable to the member with excluded discharge of indebtedness income. The IRS and Treasury Department have rejected this approach because it fails to take into account the fact that consolidated attributes that are attributable to other members will be available to offset income of the debtor member as long as the debtor is a member of the group. A separate entity approach could result in the permanent exclusion of discharge of indebtedness income when there are other attributes available to the debtor member.

In the view of the IRS and Treasury Department, the policies underlying section 108 require a consolidated approach that reduces all attributes that are available to the debtor. An approach that does not reduce all of such attributes is inconsistent with Congressional intent that income realized from debt discharge generally be deferred and not permanently eliminated. Furthermore, reducing all of the consolidated attributes available to the debtor member reflects the principle enunciated by the Supreme Court in *United Dominion Indus., Inc. v. United States*, 532 U.S. 822 (2001), that, in general, the only net operating loss of a consolidated group or its members for a consolidated return year is the consolidated net operating loss. Consistent with *United Dominion*, the tax attributes subject to reduction under section 108(b) when the debtor is a member of a consolidated group include the group's consolidated attributes in their entirety. Therefore, these temporary regulations provide for the reduction of consolidated net operating losses and all other consolidated tax attributes, including consolidated tax attributes that are attributable to members other than the debtor member.

When the debtor is a member of a consolidated group, consolidated tax attributes attributable to other members may be used to offset income of the debtor member. That ability may enable the debtor member to offset future income with the consolidated attributes attributable to other members. As a result, unless such other attributes are reduced, discharge of indebtedness income that is excluded from gross income may never result in taxable income.

Unlike consolidated attributes, the basis of assets held by members other than the debtor member is not directly available to offset income of the debtor member. In fact, the basis of assets held by members other than the debtor member may never give rise to an attribute that could be directly available to offset income of a member of the group for a consolidated return year. Therefore, as explained below, these temporary regulations provide for a reduction of basis of assets of members other than the debtor member only in limited circumstances.

2. *Ordering rule*

Under these temporary regulations, the attributes attributable to the debtor member are first subject to reduction. For this purpose, attributes attributable to the debtor member include (1) consolidated attributes attributable to the debtor member, (2) attributes that arose in separate return limitation years of the debtor member, and (3) the basis of property of the debtor member. The amount of a consolidated attribute attributable to the debtor member is determined pursuant to the principles of §1.1502–21(b). To the extent that the excluded discharge of indebtedness income exceeds the attributes attributable to the debtor member, these temporary regulations require the reduction of consolidated attributes attributable to other members and attributes attributable to members other than the debtor member that arose (or are treated as arising) in a separate return limitation year to the extent that the debtor member is a member of the separate return limitation year subgroup with respect to such attribute.

The availability of tax attributes attributable to other members of a consolidated group to reduce the future income of the debtor member creates the possibility of shifting the location of tax attributes and future tax liability. Preserving the location of tax items within the group is a fundamental policy underlying the consolidated return regulations which is reflected in a number of such regulations. See, *e.g.*, §1.1502–13 (regarding intercompany transactions); §1.1502–21 (regarding the use of attributes that arise in separate return limitation years). Location is particularly important when a member leaves the group and no longer shares the attributes attributable to it with, or uses the attributes attributable to, the other members. This sharing of tax attributes can shift the location of items within the group, affecting the amount of consolidated tax attributes that a member takes with it when it leaves the group.

The IRS and Treasury Department did not adopt an alternative consolidated approach that would require the reduction of consolidated attributes attributable to other members prior to the reduction of all of the attributes attributable to the debtor member. Such an approach would not preserve the location of income in the debtor member resulting from the reduction of attributes as effectively as the approach adopted in these temporary regulations. For example, a reduction of the consolidated attributes attributable to each member before the reduction of all of the attributes attributable to the debtor member could cause a shifting of the tax burden if the debtor member subsequently leaves the group. In that case, the debtor member may take with it a larger portion of the consolidated attributes than it otherwise would, while a portion of the consolidated attributes attributable to other members would be reduced. The larger portion of the consolidated attributes that the debtor member would take with it would be available to offset future income of the debtor member, while the remaining members of the group would bear a higher tax burden as a result of the unavailability of those consolidated attributes.

These temporary regulations achieve the dual objectives of subjecting the entire amount of consolidated attributes to reduction *and* preserving the location of future income that is deferred by first reducing attributes attributable to the debtor member, including consolidated attributes, in the order prescribed in section 108(b) and then reducing the remaining amount of consolidated attributes. This ordering rule reduces the potential to shift the location of attributes within the group.

3. *Look-through rule*

The adopted approach include a look-through rule that applies if the attribute of the debtor member reduced is the basis of stock of another member of the group. In these cases, corresponding adjustments must be made to the attributes attributable to the lower-tier member. To effect those corresponding adjustments, these temporary regulations treat the lower-tier member as a debtor member that has discharge of indebtedness income that is excluded from gross income in the amount of the stock basis reduction for purposes of the rules relating to the reduction of the attributes attributable to a debtor member. For this purpose, the consolidated attributes attributable to the lower-tier member (determined pursuant to the principles of §1.1502–21(b)) as well as the lower-tier member's separate attributes (including attributes that arose in separate return limitation years and asset basis) are available for reduction. The look-through rule is consistent with the treatment of a group as a single taxpayer under a number of the consolidated return regulations, including the provisions allowing the consolidated tax attributes attributable to one member of a group to offset income of other members of the group and the investment adjustment rules that adjust the basis of subsidiary stock to reflect the income and absorbed losses of the subsidiary.

C. *Corresponding Amendments*

Included in these temporary regulations are amendments to certain provisions of the consolidated return regulations that reflect the attribute reduction rules that apply when the debtor is a member of a consolidated group. The following paragraphs describe these amendments.

1. *The investment adjustment rules*

Under §1.1502–32(b)(3)(ii)(C), discharge of indebtedness income of a subsidiary that is excluded from gross income is treated as tax-exempt income for purposes of the investment adjustment rules only to the extent it is applied to reduce attributes. For this purpose, a discharge of indebtedness is treated as applied to reduce tax attributes only to the extent the attribute reduction is taken into account as a noncapital, nondeductible expense under §1.1502–32. The investment adjustment rules of §1.1502–32 do not apply to affect the basis of the stock of the common parent of a group. Therefore, to the extent that discharge of indebtedness income reduces consolidated attributes that are attributable to the common parent, no positive basis adjustment is made to the stock of the subsidiary. Furthermore, because the reduction of a tax credit is not a noncapital, nondeductible expense, to the extent that the discharge of indebtedness income reduces a tax credit, no positive basis adjustment is made to the stock of the subsidiary.

The IRS and Treasury Department believe that a positive basis adjustment should be made to the basis of the stock of a debtor subsidiary even if the discharge of indebtedness income reduces an attribute that is attributable to the common parent. This position is consistent with the approach of §1.1502–32 that income of a subsidiary that is offset by net operating losses generated by the common parent results in an increase in the basis of the subsidiary stock. In addition, the IRS and Treasury Department believe that a positive basis adjustment should be made to the basis of the stock of a debtor subsidiary even if the discharge of indebtedness income reduces a credit of any member. Accordingly, these temporary regulations treat as tax-exempt income discharge of indebtedness income that is excluded from gross income to the extent that such excluded income reduces tax attributes, including tax attributes attributable to the common parent and any other attribute the reduction of which is not treated as a noncapital, nondeductible expense, such as a credit.

2. *The excess loss account rules*

Under §1.1502–19, an excess loss account attributable to subsidiary stock must be included in income when an indebtedness of that subsidiary is discharged and any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under §1.1502–32. This rule may require inclusion of an excess loss account in income in an amount that is substantially greater than the amount discharged that is not treated as tax-exempt income.

The IRS and Treasury Department believe that requiring the inclusion of the excess loss account in income only to the extent of the amount discharged that is not treated as tax-exempt income is consistent with the policies underlying section 108 and the consolidated return regulations. Accordingly, these temporary regulations modify the rules of §1.1502–19 to provide that the excess loss account must be included in income only to the extent that any amount discharged that is excluded from gross income is not treated as tax-exempt income.

3. *Rules governing apportionment of net operating losses*

The temporary regulations also include modifications to the rules of §1.1502–21 relating to the amount of consolidated net operating losses apportioned to a subsidiary when a consolidated net operating loss is absorbed and when a subsidiary departs from the group. These modifications take into account the reduction of the net operating losses attributable to that member that occurs as a result of discharge of indebtedness.

D. *Request for Comments*

The IRS and Treasury Department are considering adopting rules under section 1502 (and possibly other Code sections) to address the effect of transitory transactions and other transactions designed to avoid the application of the rules concerning attribute reduction. Comments are requested regarding whether such a rule should be adopted and the appropriate scope of such a rule. Even in the absence of such a rule, such transactions may be challenged under existing law. If the IRS and Treasury Department determine such a rule is necessary to protect the policies underlying section 108 and the consolidated return regulations, the IRS and Treasury Department are prepared to promulgate such a rule with retroactive effect to discharges of indebtedness that occur after August 29, 2003.

Effective Dates

The temporary regulations related to the application of section 108(b) when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income apply to discharges of indebtedness that occur after August 29, 2003. The amendments to the investment adjustment rules apply with respect to determinations of stock basis in consolidated return years the original return for which is due (without extensions) after August 29, 2003. The amendments to the excess loss account rules apply to dispositions of subsidiary stock after August 29, 2003. However, taxpayers may apply the amendments to the investment adjustment rules and the excess loss account rules retroactively. Finally, the amendments to the net operating loss rules apply only to taxable years the original return for which the due date (without extensions) is after August 29, 2003.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding the application of section 108 when a member of a consolidated group has discharge of indebtedness income that is excluded from gross income. Current circumstances have made the application of section 108 in the consolidated group context an issue that needs to be addressed at this time. In addition, consolidated groups may be taking positions that are inconsistent with the policies underlying section 108 and the principle enunciated by the Supreme Court in *United Dominion Indus., Inc. v. United States*, 532 U.S. 822 (2001). Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

Various personnel from the IRS and Treasury Department participated in the development of the regulations.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the two entries for §1.1502–32T and adding the following entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1502–19T also issued under 26 U.S.C. 1502. * * *

Section 1.1502–28T also issued under 26 U.S.C. 1502. * * *

Section 1.1502–32T also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–19 is amended as follows:

1. Paragraph (b)(1) is revised.

2. The headings for paragraphs (h)(2) and (h)(2)(i) are revised.

3. Paragraph (h)(2)(ii) is redesignated as paragraph (h)(2)(iii).

4. New paragraph (h)(2)(ii) is added.

The revisions and addition read as follows:

§1.1502–19 Excess loss accounts.

* * * * *

(b) * * * (1) [Reserved]. For further guidance, see §1.1502–19T(b)(1).

* * * * *

(h) * * *

(2) *Dispositions of stock*—(i) *Dispositions of stock before effective date.* * * *

(ii) *Application of special limitation.* [Reserved]. For further guidance, see §1.1502–19T(h)(2)(ii).

* * * * *

Par. 3. Section 1.1502–19T is added to read as follows:

§1.1502–19T Excess loss accounts (temporary).

(a) [Reserved]. For further guidance, see §1.1502–19(a).

(b) *Excess loss account taken into account as income or gain*—(1) *Operating rules*—(i) *General rule.* Except as provided in paragraph (b)(1)(ii) of this section, if P is treated under §1.1502–19 as disposing of a share of S's stock, P takes into account its excess loss account in the share as income or gain from the disposition.

(ii) *Special limitation on amount taken into account.* Notwithstanding paragraph (b)(1)(i) of this section, if P is treated as disposing of a share of S's stock as a result of the application of §1.1502–19(c)(1)(iii)(B), the aggregate amount of its excess loss account in the shares of S's stock that P takes into account as income or gain from the disposition shall not exceed the amount of S's indebtedness that is discharged that is neither included in gross income nor treated as tax-exempt income under §1.1502–32T(b)(3)(ii)(C)(*1*). If more than one share of S's stock has an excess loss account, such excess loss accounts shall be taken into account pursuant to the preceding sentence, to the extent possible, in a manner that equalizes the excess loss accounts in S's shares that have an excess loss account.

(iii) *Treatment of disposition.* Except as provided in §1.1502–19(b)(4), the disposition is treated as a sale or exchange for purposes of determining the character of the income or gain.

(b)(2) through (h)(2)(i) [Reserved]. For further guidance, see §1.1502–19(b)(2) through (h)(2)(i).

(h)(2)(ii) *Application of special limitation.* If P was treated as disposing of stock of S because S was treated as worthless as a result of the application of §1.1502–19(c)(1)(iii)(B) after August 29, 2003, and in a consolidated return year beginning on or after January 1, 1995, the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount, are determined or redetermined with regard to paragraph (b)(1)(ii) of this section. If P was treated as disposing of stock of S because S was treated as worthless as a result of the application of §1.1502–19(c)(1)(iii)(B) on or before August 29, 2003, and in a consolidated return year beginning on or after January 1, 1995, the group may determine or redetermine the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount with regard to paragraph (b)(1)(ii) of this section.

(h)(2)(iii) through (h)(3) [Reserved]. For further guidance, see §1.1502–19(h)(2)(iii) through (h)(3).

Par. 4. Section 1.1502–21 is amended as follows:

1. Paragraphs (b)(2)(iv) and (c)(2)(vii) are revised.

2. Paragraphs (h)(6) and (h)(7) are redesignated as paragraphs (h)(7) and (h)(8), respectively.

3. New paragraph (h)(6) is added.

4. Newly designated paragraph (h)(8) is revised.

The revision and additions read as follows:

§1.1502–21 Net operating losses.

* * * * *

(b) * * *

(2) * * *

(iv) [Reserved]. For further guidance, see §1.1502–21T(b)(2)(iv).

* * * * *

(c) * * *

(2) * * *

(vii) [Reserved]. For further guidance, see §1.1502–21T(c)(2)(vii).

* * * * *

(h) * * *

(6) [Reserved]. For further guidance, see §1.1502–21T(h)(6).

* * * * *

(8) [Reserved]. For further guidance, see §1.1502–21T(h)(8).

Par. 5. Section 1.1502–21T is amended as follows:

1. Paragraphs (b)(1) through (b)(3)(ii)(B) are revised.

2. Paragraphs (c) through (h)(7) are revised.

3. Paragraph (h)(8) is added.

The revisions and addition read as follows:

§1.1502–21T Net operating losses (temporary).

* * * * *

(b) * * *

(1) *Carryovers and carrybacks generally.* The net operating loss carryovers and carrybacks to a taxable year are determined under the principles of section 172 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a *pro rata* basis. In addition, the amount of any CNOL absorbed by the group in any year is apportioned among members based on the percentage of the CNOL attributable to each member as of the beginning of the year. The percentage of the CNOL attributable to a member is determined pursuant to paragraph (b)(2)(iv)(B) of this section. Additional rules provided under the Internal Revenue Code or regulations also apply. See, *e.g.*, section 382(l)(2)(B) (if losses are carried from the same taxable year, losses subject to limitation under section 382 are absorbed before losses that are not subject to limitation under section 382). See §1.1502–21(c)(1)(iii), *Example 2*, for an illustration of *pro rata* absorption of losses subject to a SRLY limitation. See paragraph (b)(3)(v) of this section regarding the treatment of any loss that is treated as expired under §1.1502–35T(f)(1).

(2)(i) through (iii) [Reserved]. For further guidance, see §1.1502–21(b)(2)(i) through (iii).

(iv) *Operating rules*—(A) *Amount of CNOL attributable to a member.* The amount of a CNOL that is attributable to a member shall equal the product of the CNOL and the percentage of the CNOL attributable to such member.

(B) *Percentage of CNOL attributable to a member*—(*1*) *In general.* Except as provided in paragraph (b)(2)(iv)(B)(*2*) of this section, the percentage of the CNOL attributable to a member shall equal the separate net operating loss of the member for the year of the loss divided by the sum of the separate net operating losses for that year of all members having such losses. For this purpose, the separate net operating loss of a member is determined by computing the CNOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by the member).

(*2*) *Special rule.* If during a taxable year either a member realizes discharge of indebtedness income that is excluded from gross income under section 108(a) and such amount reduces any portion of the CNOL attributable to such member pursuant to section 108 and §1.1502–28T, or a member that had a separate net operating loss for the year of the CNOL ceases to be a member, the percentage of the CNOL attributable to each member as of the first day of the following taxable year shall be recomputed. In addition, if a portion of the CNOL attributable to a member for a taxable year is carried back to a separate return year, the percentage of the CNOL attributable to each member as of the first day of the taxable year following the taxable year of the CNOL shall be recomputed. In each case, such recomputed percentage shall equal the unabsorbed CNOL attributable to the member on the first day of the following taxable year divided by the sum of the unabsorbed CNOL attributable to all of the members on the first day of the following taxable year. For purposes of the preceding sentence, a CNOL that is reduced pursuant to section 108 and §1.1502–28T or that is otherwise permanently disallowed or eliminated shall be treated as absorbed.

(b)(2)(v) through (b)(3)(ii)(B) [Reserved]. For further guidance, see §1.1502–21(b)(2)(v) through (b)(3)(ii)(B).

* * * * *

(c)(1) through (c)(2)(vi) [Reserved]. For further guidance, see §1.1502–21(c)(1) through (c)(2)(vi).

(vii) *Corporations that leave a SRLY subgroup.* If a loss member ceases to be affiliated with a SRLY subgroup, the amount of the member's remaining SRLY loss from a specific year is determined pursuant to the principles of §1.1502–21(b)(2)(ii)(A) and §1.1502–21T(b)(2)(iv).

(c)(2)(viii) through (h)(5) [Reserved]. For further guidance, see §1.1502–21(c)(2)(viii) through (h)(5).

(6) *Certain prior periods.* Paragraphs (b)(1), (b)(2)(iv), and (c)(2)(vii) of this section shall only apply to taxable years the original return for which the due date (without extensions) is after August 29, 2003. For taxable years the original return for which the due date (without extensions) is on or before August 29, 2003, see paragraphs (b)(1), (b)(2)(iv), and (c)(2)(vii) of §1.1502–21 and paragraph (b)(1) of §1.1502–21T as contained in 26 CFR part 1 revised April 1, 2003.

(7) [Reserved]. For further guidance, see §1.1502–21(h)(7).

(8) *Losses treated as expired under §1.1502–35T(f)(1).* Paragraph (b)(3)(v) of this section is effective for losses treated as expired under §1.1502–35T(f)(1) on and after March 7, 2002, and no later than March 11, 2006.

Par. 6. Section 1.1502–28T is added to read as follows:

§1.1502–28T Consolidated section 108 (temporary).

(a) *In general.* This section sets forth rules for the application of section 108(a) and the reduction of tax attributes pursuant to section 108(b) when a member of the group realizes discharge of indebtedness income that is excluded from gross income under section 108(a) (excluded COD income).

(1) *Application of section 108(a).* Section 108(a)(1)(B) is applied separately to each member that realizes excluded COD income. Therefore, the limitation of section 108(a)(3) on the amount of discharge of indebtedness income that is treated as excluded COD income is determined based on the assets (including stock and securities of other members) and liabilities (including liabilities to other members) of only the member that realizes excluded COD income.

(2) *Reduction of tax attributes attributable to the debtor*—(i) *In general.* With respect to a member that realizes excluded COD income in a taxable year, the tax attributes attributable to that member (and its direct and indirect subsidiaries to the extent required by section 1017(b)(3)(D) and paragraph (a)(3) of this section), including basis of assets and losses and credits arising in separate return limitation years, shall be reduced as provided in sections 108 and 1017 and this section. Basis of subsidiary stock, however, shall not be reduced below zero.

(ii) *Consolidated tax attributes attributable to a member.* For purposes of this section, the amount of a consolidated tax attribute that is attributable to a member shall be determined pursuant to the principles of §1.1502–21T(b)(2)(iv). In addition, if the member is a member of a separate return limitation year subgroup, the amount of a tax attribute that arose in a separate return limitation year that is attributable to that member shall also be determined pursuant to the principles of §1.1502–21T(b)(2)(iv).

(3) *Look-through rules*—(i) *Priority of section 1017(b)(3)(D).* If a member treats stock of a subsidiary as depreciable property pursuant to section 1017(b)(3)(D), the basis of the depreciable property of such subsidiary shall be reduced pursuant to section 1017(b)(3)(D) prior to the application of paragraph (a)(3)(ii) of this section.

(ii) *Application of additional look-through rule.* If the basis of stock of a member (the lower-tier member) that is owned by another member is reduced pursuant to section 108, section 1017, and paragraph (a)(2) of this section (but not as a result of treating subsidiary stock as depreciable property pursuant to section 1017(b)(3)(D)), solely for purposes of sections 108 and 1017 and this section other than paragraphs (a)(4) and (b)(1) of this section, the lower-tier member shall be treated as realizing excluded COD income. The amount of such excluded COD income shall be the amount of such basis reduction. Accordingly, the tax attributes attributable to such lower-tier member shall be reduced as provided in sections 108 and 1017 and this section. To the extent that the excluded COD income realized by the lower-tier member pursuant to this paragraph (a)(3) does not reduce a tax attribute attributable to the lower-tier member, such excluded COD income shall not be applied to reduce tax attributes attributable to any member under paragraph (a)(4) of this section.

(4) *Reduction of certain tax attributes attributable to other members.* To the extent that, pursuant to paragraph (a)(2) of this section, the excluded COD income is not applied to reduce the tax attributes attributable to the member that realizes the excluded COD income, after the application of paragraph (a)(3) of this section, such amount shall be applied to reduce the remaining consolidated tax attributes of the group as provided in section 108 and this section. Such amount also shall be applied to reduce the tax attributes attributable to members that arose (or are treated as arising) in a separate return limitation year to the extent that the member that realizes excluded COD income is a member of the separate return limitation year subgroup with respect to such attribute. The reduction of each tax attribute pursuant to the two preceding sentences shall be made in the order prescribed in section 108 and pursuant to §1.1502–21T(b)(1). Except to the extent that the member that realizes excluded COD income is a member of the separate return limitation year subgroup with respect to a tax attribute that arose (or is treated as arising) in a separate return limitation year, such attribute is not subject to reduction pursuant to this paragraph (a)(4). In addition, basis in assets is not subject to reduction pursuant to this paragraph (a)(4). Finally, to the extent that the realization of excluded COD income by a member pursuant to paragraph (a)(3) does not reduce a tax attribute attributable to such lower-tier member, such excess shall not be applied to reduce tax attributes attributable to any member pursuant to this paragraph (a)(4).

(b) *Special rules*—(1) *Multiple debtor members*—(i) *Reduction of tax attributes attributable to debtor members prior to reduction of consolidated tax attributes.* If in a single taxable year multiple members realize excluded COD income, paragraphs (a)(2) and (3) of this section shall apply with respect to the excluded COD income of each such member prior to the application of paragraph (a)(4) of this section.

(ii) *Reduction of higher-tier debtor's tax attributes.* If in a single taxable year multiple members realize excluded COD income and one such member is a higher-tier member of another such member, paragraphs (a)(2) and (3) of this section shall be applied with respect to the excluded COD income of the higher-tier member before such paragraphs are applied to the excluded COD income of the other such member. A member (the first member) is a higher-tier member of another member (the second member) if the first member is the common parent or investment adjustments under §1.1502–32 or §1.1502–32T with respect to the stock of the second member would affect investment adjustments with respect to the stock of the first member.

(iii) *Reduction of additional tax attributes.* If more than one member realizes excluded COD income that has not been applied to reduce a tax attribute attributable to such member (the remaining COD amount) and the remaining tax attributes available for reduction under paragraph (a)(4) of this section are less than the aggregate of the remaining COD amounts, after the application of paragraph (a)(2) of this section, each such member's remaining COD amount shall be applied on a *pro rata* basis (based on the relative remaining COD amounts), pursuant to paragraph (a)(4) of this section, to reduce such remaining available tax attributes.

(2) *Election under section 108(b)(5).* Any member that realizes excluded COD income may make the election described in section 108(b)(5). The election is made separately for each member. Therefore, an election may be made for one member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of this section) while another election, or no election, may be made for another member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of

this section). See §1.108–4 for rules relating to the procedure for making an election under section 108(b)(5).

(3) *Limitation of section 1017(b)(2).* The limitation of section 1017(b)(2) on the reduction in basis of property shall be applied by reference to the aggregate of the basis of the property held by the member that realizes excluded COD income, not the aggregate of the basis of the property held by all of the members of the group, and the liabilities of such member, not the aggregate liabilities of all of the members of the group.

(c) *Examples.* The principles of paragraphs (a) and (b) of this section are illustrated by the following examples. Unless otherwise indicated, no election under section 108(b)(5) has been made. The examples are as follows:

Example 1. (i) *Facts.* P is the common parent of a consolidated group that includes subsidiaries S1 and S2. P owns 80 percent of the stock of S1 and 100 percent of the stock of S2. In Year 1, the P group sustained a $250 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $125 was attributable to P and $125 was attributable to S1. On Day 1 of Year 2, S2 joined the P group. As of the beginning of Year 2, S2 had a $50 net operating loss carryover from Year 1, a separate return limitation year. In Year 2, the P group sustained a $200 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $90 was attributable to P, $70 was attributable to S1, and $40 was attributable to S2. In Year 3, S2 realized $200 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S2 had no liabilities. In that same year, the P group sustained a $50 consolidated net operating loss, of which $40 was attributable to S1 and $10 was attributable to S2 under the principles of §1.1502–21T(b)(2)(iv). As of the beginning of Year 4, S2 had Asset A with a basis of $40 and a fair market value of $10.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtor.* Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S2 must first be reduced to take into account its excluded COD income in the amount of $200.

(*1*) *Reduction of net operating losses.* Pursuant to section 108(b)(2)(A), the net operating loss and the net operating loss carryovers of S2 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S2 under the principles of §1.1502–21T(b)(2)(iv) are reduced first. Accordingly, the consolidated net operating loss for Year 3 is reduced by $10, the portion of the consolidated net operating loss attributable to S2, to $40. Then, again pursuant to section 108(b)(4)(B), S2's net operating loss carryover of $50 from its separate return limitation year is reduced to $0. Finally, the consolidated net operating loss carryover from Year 2 is reduced by $40, the portion of that consolidated net operating loss carryover attributable to S2, to $160.

(*2*) *Reduction of basis.* Following the reduction of the net operating loss and the net operating loss carryovers attributable to S2, S2 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S2 reduces its basis in Asset A by $40, from $40 to $0.

(B) *Reduction of remaining consolidated tax attributes.* The remaining $60 of excluded COD income then reduces consolidated tax attributes pursuant to paragraph (a)(4) of this section. In particular, the remaining $40 consolidated net operating loss for Year 3 is reduced to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by $20 from $250 to $230. Pursuant to paragraph (a)(4) of this section, a *pro rata* amount of the consolidated net operating loss carryover from Year 1 that is attributable to each of P and S1 is treated as reduced. Therefore, $10 of the consolidated net operating loss carryover from Year 1 that is attributable to each of P and S1 is treated as reduced.

Example 2. (i) *Facts.* P is the common parent of a consolidated group that includes subsidiaries S1 and S2. P owns 100 percent of the stock of S1 and S1 owns 100 percent of the stock of S2. None of P, S1, or S2 has a separate return limitation year. In Year 1, the P group sustained a $50 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $10 was attributable to P, $20 was attributable to S1, and $20 was attributable to S2. In Year 2, the P group sustained a $70 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $30 was attributable to P, $30 was attributable to S1, and $10 was attributable to S2. In Year 3, S1 realized $170 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S1 and S2 had no liabilities. In that same year, the P group sustained a $50 consolidated net operating loss, of which $10 was attributable to S1 and $40 was attributable to S2 under the principles of §1.1502–21T(b)(2)(iv). As of the beginning of Year 4, S1's sole asset was the stock of S2, and S1 had a $80 basis in the S2 stock. In addition, at the beginning of Year 4, S2 had an asset with a $0 basis and a $10 value.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtor.* Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 must first be reduced to take into account its excluded COD income in the amount of $170.

(*1*) *Reduction of net operating losses.* Pursuant to section 108(b)(2)(A), the net operating loss and the net operating loss carryovers of S1 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the principles of §1.1502–21T(b)(2)(iv) are reduced first. Accordingly, the consolidated net operating loss for Year 3 is reduced by $10, the portion of the consolidated net operating loss for Year 3 attributable to S1, to $40. Then, the consolidated net operating loss carryover from Year 1 is reduced by $20, the portion of that consolidated net operating loss carryover attributable to S1, to $30, and the consolidated net operating loss carryover from Year 2 is reduced by $30, the portion of that consolidated net operating loss carryover attributable to S1, to $40.

(*2*) *Reduction of basis.* Following the reduction of the net operating loss and the net operating loss carryovers attributable to S1, S1 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S1 reduces its basis in the stock of S2 by $80, from $80 to $0.

(*3*) *Tiering down of stock basis reduction.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S2 is treated as realizing $80 of excluded COD income. Accordingly, the consolidated net operating loss for Year 3 is reduced by an additional $40, the portion of the consolidated net operating loss for Year 3 attributable to S2, to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by $20, the portion of that consolidated net operating loss carryover attributable to S2, to $10. Then, the consolidated net operating loss carryover from Year 2 is reduced by $10, the portion of that consolidated net operating loss carryover attributable to S2, to $30. S2's remaining $10 of excluded COD income does not reduce consolidated tax attributes attributable to P or S1 under paragraph (a)(4) of this section.

(B) *Reduction of remaining consolidated tax attributes.* Finally, pursuant to paragraph (a)(4) of this section, S1's remaining $30 of excluded COD income reduces the remaining consolidated tax attributes. In particular, the remaining $10 consolidated net operating loss carryover from Year 1 is reduced by $10 to $0, and the remaining $30 consolidated net operating loss carryover from Year 2 is reduced by $20 to $10.

Example 3. (i) *Facts.* P is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P owns 100 percent of the stock of S1, S1 owns 100 percent of the stock of S2, and S2 owns 100 percent of the stock of S3. In Year 1, the P group sustained a $150 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $50 was attributable to S2, and $100 was attributable to S3. In Year 2, the P group sustained a $50 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $40 was attributable to S1 and $10 was attributable to S2. In Year 3, S1 realized $170 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S1, S2, and S3 had no liabilities. In that same year, the P group sustained a $50 consolidated net operating loss, of which $10 was attributable to S1, $20 was attributable to S2, and $20 was attributable to S3 under the principles of §1.1502–21T(b)(2)(iv). At the beginning of Year 4, S1's only asset was the stock of S2, with a basis of $120, and S2's only asset was the stock of S3 with a basis of $180 and a value of $10. None of P, S1, or S2 had a separate return limitation year.

(ii) *Analysis—Reduction of tax attributes attributable to debtor.* Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 must first be reduced to take into account its excluded COD income in the amount of $170.

(A) *Reduction of net operating losses.* Pursuant to section 108(b)(2)(A), the net operating loss and the net operating loss carryovers of S1 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the principles of §1.1502–21T(b)(2)(iv) are reduced first. Pursuant to section 108(b)(4)(B), S1's net operating loss for the taxable year of the discharge is reduced first. Accordingly, the consolidated net operating loss for Year

3 is reduced by $10, the portion of the consolidated net operating loss attributable to S1, to $40. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is reduced by $40, the portion of that consolidated net operating loss carryover attributable to S1, to $10.

(B) *Reduction of basis.* Following the reduction of the net operating loss and the net operating loss carryovers attributable to S1, S1 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S1 reduces its basis in the stock of S2 by $120, from $120 to $0.

(C) *Tiering down of stock basis reduction to S2.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S2 is treated as realizing $120 of excluded COD income. Pursuant to section 108(b)(2)(A), therefore, the net operating loss and net operating loss carryovers of S2 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S2 under the principles of §1.1502–21T(b)(2)(iv) are reduced. Pursuant to section 108(b)(4)(B), S2's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by $20, the portion of the consolidated net operating loss attributable to S2, to $20. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 1 is reduced by $50, the portion of that consolidated net operating loss carryover attributable to S2, to $100. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is further reduced by $10, the portion of that consolidated net operating loss carryover attributable to S2, to $0. Following the reduction of the net operating loss and the net operating loss carryovers attributable to S2, S2 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S2 reduces its basis in its S3 stock by $40 to $140.

(D) *Tiering down of stock basis reduction to S3.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S3 is treated as realizing $40 of excluded COD income. Pursuant to section 108(b)(2)(A), therefore, the net operating loss and the net operating loss carryovers of S3 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S3 under the principles of §1.1502–21T(b)(2)(iv) are reduced. Pursuant to section 108(b)(4)(B), S3's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by $20, the portion of the consolidated net operating loss attributable to S3, to $0. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 1 is reduced by $20, the lesser of the portion of that consolidated net operating loss carryover attributable to S3 and the remaining excluded COD income, to $80.

Example 4. (i) *Facts.* P is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P owns 100 percent of the stock of each of S1 and S2. Each of S1 and S2 owns stock of S3 that represents 50 percent of the value of the stock of S3. In Year 1, the P group sustained a $160 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $10 was attributable to P, $50 was attributable to S2, and $100 was attributable to S3. In Year 2, the P group sustained a $110 consolidated net operating loss. Under the principles of §1.1502–21T(b)(2)(iv), of that amount, $40 was attributable to S1 and $70 was attributable to S2. In Year 3, S1 realized $200 of excluded COD income from the discharge of non-intercompany indebtedness, and S2 realized $270 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S1, S2, and S3 had no liabilities. In that same year, the P group sustained a $50 consolidated net operating loss, of which $10 was attributable to S1, $20 was attributable to S2, and $20 was attributable to S3 under the principles of §1.1502–21T(b)(2)(iv). At the beginning of Year 4, S1's basis in its S3 stock was $60, S2's basis in its S3 stock was $120, and S3 had one asset with a basis of $200 and a value of $10. None of P, S1, S2, or S3 had a separate return limitation year.

(ii) *Analysis—Reduction of tax attributes attributable to debtors.* Pursuant to paragraph (b)(1)(i) of this section, the tax attributes attributable to each of S1 and S2 are reduced pursuant to paragraph (a)(2) of this section, and the tax attributes attributable to S3 are reduced pursuant to paragraph (a)(3) of this section so as to reflect a reduction of S1's and S2's basis in the stock of S3 prior to the application of paragraph (a)(4) to reduce additional tax attributes. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 and S2 must be reduced to take into account their excluded COD income.

(A) *Reduction of net operating losses generally.* Pursuant to section 108(b)(2)(A), the net operating losses and the net operating loss carryovers of S1 and S2 are reduced. Pursuant to section 108(b)(4)(B) and paragraph (a) of this section, the net operating losses and the net operating loss carryovers attributable to S1 and S2 under the principles of §1.1502–21T(b)(2)(iv) are reduced first.

(B) *Reduction of net operating losses attributable to S1.* Pursuant to section 108(b)(4)(B), S1's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is reduced by $10, the portion of the consolidated net operating loss attributable to S1, to $40. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is reduced by $40, the portion of that consolidated net operating loss carryover attributable to S1, to $70.

(C) *Reduction of net operating losses attributable to S2.* Pursuant to section 108(b)(4)(B), S2's net operating loss for the taxable year of the discharge is reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by $20, the portion of the consolidated net operating loss attributable to S2, to $20. Then, pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 1 is reduced by $50, the portion of that consolidated net operating loss carryover attributable to S2, to $110. Then, again pursuant to section 108(b)(4)(B), the consolidated net operating loss carryover from Year 2 is further reduced by $70, the portion of that consolidated net operating loss carryover attributable to S2, to $0.

(D) *Reduction of basis.* Following the reduction of the net operating losses and the net operating loss carryovers attributable to S1 and S2, S1 and S2 must reduce their basis in their assets pursuant to section 1017 and §1.1017–1. Accordingly, S1 reduces its basis in the stock of S3 by $60, from $60 to $0, and S2 reduces its basis in the stock of S3 by $120, from $120 to $0.

(E) *Tiering down of basis reduction.* Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S3 is treated as realizing $180 of excluded COD income. Pursuant to section 108(b)(2)(A), therefore, the net operating loss and the net operating loss carryovers of S3 are reduced, in the order indicated by section 108(b)(4)(B). Pursuant to paragraph (a)(2) of this section the consolidated net operating loss and any consolidated net operating loss carryovers that are attributable to S3 under the principles of §1.1502–21T(b)(2)(iv) are reduced. Accordingly, the consolidated net operating loss for Year 3 is further reduced by $20, the portion of the consolidated net operating loss attributable to S3, to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by $100, the portion of that consolidated net operating loss carryover attributable to S3, to $10. Following the reduction of the net operating loss and the net operating loss carryover attributable to S3, S3 reduces its basis in its asset pursuant to section 1017 and §1.1017–1. Accordingly, S3 reduces its basis in its asset by $60, from $200 to $140.

(F) *Reduction of remaining consolidated tax attributes.* Finally, pursuant to paragraph (a)(4) of this section, the remaining $90 of S1's excluded COD income and the remaining $10 of S2's excluded COD income reduce the remaining consolidated tax attributes. In particular, the remaining $10 consolidated net operating loss carryover from Year 1 is reduced by $10 to $0. Because that amount is less than the aggregate amount of remaining excluded COD income, such income is applied on a *pro rata* basis to reduce the remaining consolidated tax attributes. Accordingly, $9 of S1's remaining excluded COD income and $1 of S2's remaining excluded COD income is applied to reduce the remaining consolidated net operating loss carryover from Year 1. Consequently, of S1's excluded COD income of $200, only $119 is applied to reduce tax attributes, and, of S2's excluded COD income of $270, only $261 is applied to reduce tax attributes.

(d) *Effective date.* This section applies to discharges of indebtedness that occur after August 29, 2003.

Par. 7. Section 1.1502–32 is amended as follows:

1. Paragraphs (b)(3)(ii)(C)(*1*) and (b)(3)(iii)(A) are revised.

2. Paragraph (b)(4)(vii) is added.

3. Paragraph (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), are revised.

4. Paragraph (h)(7) is added.

The revisions and additions read as follows:

§1.1502–32 Investment adjustments.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

(C) * * *

(*1*) [Reserved]. For further guidance, see §1.1502–32T(b)(3)(ii)(C)(1).

* * * * *

(iii) * * *

(A) [Reserved]. For further guidance, see §1.1502–32T(b)(3)(iii)(A).

* * * * *

(4) * * *

(vii) [Reserved]. For further guidance, see §1.1502–32T(b)(4)(vii).

(5) * * *

(ii) * * *

Example 4(a), (b), and (c) [Reserved]. For further guidance, see §1.1502–32T(b)(5)(ii), *Example 4*(a), (b), and (c).

* * * * *

(h) * * *

(7) [Reserved]. For further guidance, see §1.1502–32T(h)(7).

Par. 8. Section 1.1502–32T is amended as follows:

1. Paragraphs (b) through (b)(3)(iii)(B) are revised.

2. Add and reserve paragraph (b)(3)(iv) and revise paragraphs (b)(4) through (b)(4)(iv).

3. Add and reserve paragraph (b)(5) and revise paragraphs (c) through (h)(5)(ii).

4. Paragraph (h)(7) is added.

The revisions and addition read as follows:

§1.1502–32T Investment adjustments (temporary).

* * * * *

(b) through (b)(3)(ii)(B) [Reserved]. For further guidance, see §1.1502–32(b) through (b)(3)(ii)(B).

(C) *Discharge of indebtedness income—(1) In general.* Discharge of indebtedness income of S that is excluded from gross income under section 108 is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes attributable to any member of the group under section 108, section 1017, or §1.1502–28T. If S is treated as realizing discharge of indebtedness income that is excluded from gross income pursuant to §1.1502–28T(a)(3), S shall not be treated as realizing excluded COD income for purposes of the preceding sentence.

(b)(3)(ii)(C)(*2*) through (b)(3)(ii)(D) [Reserved]. For further guidance, see §1.1502–32(b)(3)(ii)(C)(*2*) through (b)(3)(ii)(D).

(iii) *Noncapital, nondeductible expenses*—(A) *In general.* S's noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss, and that decrease, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses. Similarly, if a loss carryover (*e.g.*, under section 172 or 1212) attributable to S expires or is reduced under section 108(b) and §1.1502–28T, it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried. However, when a tax attribute attributable to S is reduced as required pursuant to §1.1502–28T(a)(3), the reduction of the tax attribute is not treated as a noncapital, nondeductible expense of S. Finally, if S sells and repurchases a security subject to section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustments under section 1091(d) prevent the disallowance from being permanent.

(b)(3)(iii)(B) [Reserved]. For further guidance, see §1.1502–32(b)(3)(iii)(B).

* * * * *

(b)(3)(iv) through (b)(4)(iv) [Reserved]. For further guidance, see §1.1502–32(b)(3)(iv) through (b)(4)(iv).

* * * * *

(b)(5)(i) through (b)(5)(ii), *Example 3* [Reserved]. For further guidance, see §1.1502–32(b)(5)(i) through (b)(5)(ii), *Example 3*.

Example 4. Discharge of indebtedness. (a) *Facts.* P forms S on January 1 of Year 1 and S borrows $200. During Year 1, S's assets decline in value and the P group has a $100 consolidated net operating loss. Of that amount, $10 is attributable to P and $90 is attributable to S under the principles of §1.1502–21T(b)(2)(iv). None of the loss is absorbed by the group in Year 1, and S is discharged from $100 of indebtedness at the close of Year 1. P has a $0 basis in the S stock. P and S have no attributes other than the consolidated net operating loss. Under section 108(a), S's $100 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and §1.1502–28T, the consolidated net operating loss is reduced to $0.

(b) *Analysis.* Under §1.1502–32(b)(3)(iii)(B), the reduction of $90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense in Year 1 because that loss is permanently disallowed by section 108(b) and §1.1502–28T. Under paragraph (b)(3)(ii)(C)(*1*) of this section, all $100 of S's discharge of indebtedness income is treated as tax-exempt income in Year 1 because the discharge results in a $100 reduction to the consolidated net operating loss. Consequently, the loss and the cancellation of the indebtedness result in a net positive $10 adjustment to P's basis in its S stock.

(c) *Insufficient attributes.* The facts are the same as in paragraph (a) of this *Example 4*, except that S is discharged from $120 of indebtedness at the close of Year 1. Under section 108(a), S's $120 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and §1.1502–28T, the consolidated net operating loss is reduced to $0 at the close of Year 1. Under §1.1502–32(b)(3)(iii)(B), the reduction of $90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense. Under paragraph (b)(3)(ii)(C)(*1*) of this section, only $100 of the discharge is treated as tax-exempt income because only that amount is applied to reduce tax attributes. The remaining $20 of discharge income excluded under section 108(a) has no effect on P's basis in S's stock.

(b)(5)(ii), *Example 4*(d) through (h)(5)(ii) [Reserved]. For further guidance, see §1.1502–32(b)(5)(ii), *Example 4*(d) through (h)(5)(ii).

* * * * *

(h)(7) *Rules related to discharges of indebtedness excluded from gross income.* Paragraphs (b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), of this section apply with respect to determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without extensions) after August 29, 2003. For determinations in consolidated return years the original return for which is due (without extensions) on or before August 29, 2003, groups may apply paragraphs (b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), of this section without regard to the references to §1.1502–28T or, alternatively, apply paragraphs (b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c), of §1.1502–32 as contained in 26 CFR part 1 edition revised as of April 1, 2003.

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved August 28, 2003.

Gregory F. Jenner,
Deputy Assistant Secretary of the Treasury.

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Section 6103.—Confidentiality and Disclosure of Returns and Return Information

26 CFR 301.6103: Confidentiality and disclosure of returns and return information.
26 CFR 301.6104: Public inspection of material relating to tax-exempt organizations.
26 CFR 601.702: Publication, public inspection and specific requests for records.

How may a person obtain copies of returns or return information? See Rev. Proc. 2003-74, page 923.

Section 6104.—Publicity of Information Required From Certain Exempt Organizations and Certain Trusts

26 CFR 301.6103: Confidentiality and disclosure of returns and return information.
26 CFR 301.6104: Public inspection of material relating to tax-exempt organizations.
26 CFR 601.702: Publication, public inspection and specific requests for records.

How may a person obtain copies of returns or return information? See Rev. Proc. 2003-74, page 923.

Part III. Administrative, Procedural, and Miscellaneous

Proposed Revenue Procedure Regarding Home-Care Service Procedures

Notice 2003–70

Purpose

This notice contains a proposed revenue procedure giving updated guidance to state and local government agencies on how they can serve as agents, under section 3504, for disabled individuals and other welfare recipients who employ home-care service providers to assist them in their homes ("service recipients").

Service recipients who are the common law employers of these home-care service providers may designate an agent under section 3504 to meet certain Federal employment tax responsibilities on behalf of the employer, such as withholding and reporting. The general procedures for designating an agent and reporting and filing as an agent are set forth in Rev. Proc. 70–6, 1970–1 C.B. 420. A state or local government agency can be authorized to serve as a section 3504 agent for service recipients (a "state agent") enrolled in a program it administers. Special procedures for designating a state agent and for reporting and filing as a state agent are set forth in Rev. Proc. 80–4, 1980–1 C.B. 581.

The proposed revenue procedure would modify the existing guidance to make clear that the special procedures of Rev. Proc. 80–4 apply not only when a state or local government agency furnishes the home-care service providers but also when the service recipients hire their own home-care service providers directly. The proposed revenue procedure also provides guidance on withholding and reporting procedures when a state or local agency that is designated as a state agent in accordance with Rev. Proc. 80–4 engages a subagent or reporting agent to perform payroll and employment tax functions for the service recipients in the program.

Purpose and Contents of Proposed Revenue Procedure

By its terms, Rev. Proc. 80–4 applies when a state or local health and welfare agency wishes to become a section 3504 agent "for welfare recipients who become the employers of individuals furnished by the agencies to provide in-home domestic service for the welfare recipients." *See* Rev. Proc. 80–4, sec. 1. Since Rev. Proc. 80–4 was issued, the home-care service industry has changed. Now, although the state and local agencies still provide some or all of the funds to pay the home-care service providers, service recipients frequently recruit, hire, and train their home-care service providers. The proposed revenue procedure modifies Rev. Proc. 80–4 to establish that its provisions also apply to state and local agencies that do not furnish the individuals to provide in-home domestic services. Therefore, a state may be authorized to serve as a section 3504 agent for a service recipient and may report and file in accordance with the specialized procedures of Rev. Proc. 80–4 even though the state does not furnish the individual or individuals that provide the home-care services to the service recipient.

The proposed revenue procedure also reviews, through a series of questions and answers, the operation of the specialized procedures, and incorporates aspects of the procedures that were added by Notice 95–18, 1995–1 C.B. 300, which provided guidance generally about reporting and withholding of employment taxes for household employees. Specifically, the proposed revenue procedure makes clear that the state is not required to submit a Form 2678 with the application package it submits to the Service requesting authorization to act as agent. Additionally, the proposed revenue procedure allows the state to obtain a special EIN (as originally authorized by Notice 95–18) for purposes of withholding, reporting and paying on behalf of service recipients; file an aggregate Form 940 to report FUTA on behalf of the service recipients; and remit taxes with a timely filed return rather than making deposits according to the schedule that would otherwise be applicable under section 31.6302–1 of the Employment Tax Regulations.

The proposed revenue procedure also makes clear that the service recipient can designate the state as agent without having to obtain an EIN as he or she would otherwise be required to do in order to execute a Form 2678.

The proposed revenue procedure also addresses questions that have arisen in light of another evolving aspect of the home-care service industry. States now often engage third parties to participate in various aspects of their home-care service programs, including processing federal grants and administering payroll for home-care service providers. In the home-care service industry, these third parties are sometimes referred to as fiscal intermediaries. For Federal employment tax purposes, the proposed revenue procedure provides guidance on withholding and reporting rules for the third parties when acting either as a subagent of the state agent or as a reporting agent of the state. The Service recognizes that there are a variety of third parties involved in these arrangements, some for-profit, some nonprofit, and some public, and that the terms of the agreements between the states and the third parties also vary. The Service specifically requests comments on the guidance provided in the proposed revenue procedure with respect to use of third party arrangements and suggestions for any additional guidance that may be appropriate or helpful.

Effective Date

Once issued in final form, the proposed revenue procedure will be effective no earlier than January 1, 2005. Until a final version of the proposed revenue procedure is issued, the Service will not challenge the way a state meets the employment tax obligations with respect to home-care service providers employed in its in-home domestic services program if the employment taxes are being timely withheld, reported and paid and the procedures for reporting and paying the taxes are based on a reasonable, good faith interpretation of existing guidance, including Rev. Procs. 70–6 and 80–4 and Notice 95–18. Whether a state has made a reasonable, good faith interpretation of existing guidance will be based on all of the relevant facts and circumstances. Reliance on the positions set forth in the proposed revenue procedure before the effective date will be considered a reasonable, good faith interpretation of existing guidance.

Request for Comments

Comments are requested on the proposed revenue procedure. Comments may be submitted on or before January 26, 2004, to Internal Revenue Service, PO Box 7604, Washington, DC 20044, Attn: CC:PA:LPD:PR (Notice 2003–70), Room 5203. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington, DC 20224, Attn: CC:PA:LPD:PR (Notice 2003–70), Room 5203. Submissions may also be sent electronically via the internet to the following email address: *Notice.comments@irscounsel.treas.gov*. Include the notice number (Notice 2003–70) in the subject line.

Drafting Information

The principal author of this notice is Paul J. Carlino of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Service and Treasury Department participated in the development of this notice. For further information regarding this notice, contact Mr. Carlino at (202) 622–6040 (not a toll-free call).

Proposed Revenue Procedure

I. PURPOSE

This revenue procedure gives updated guidance to state and local government agencies on how they can be designated as agents, under section 3504 of the Internal Revenue Code (the Code), for disabled individuals and other welfare recipients who employ home-care service providers to assist them in their homes ("service recipients"). Specifically, the revenue procedure makes clear that the special procedures for designating an agent set forth in Rev. Proc. 80–4, 1980–1 C.B. 581, apply not only when the state or local government agency furnishes the home-care service providers but also when the service recipients hire their own home-care service providers directly. The proposed revenue procedure also reviews the procedures for withholding, reporting and payment of employment taxes when a state or local agency is designated as an agent under section 3504 of the Code for service recipients (a "state agent") in accordance with Rev. Proc. 80–4, and provides guidance on withholding, reporting and payment of employment taxes when a state agent in turn engages a subagent or reporting agent to perform payroll and employment tax functions for service recipients in the program.

II. BACKGROUND

A. *Employment Tax Treatment of Household Employees*

For 2003, a household employer is not required to withhold or pay Federal Insurance Contributions Act (FICA) taxes with respect to *cash* wages of less than $1,400 paid to an employee performing services of a household nature in the employer's home (a "household employee"). When the cash wages paid to such a household employee equal $1,400 or more, all of the cash wages (including the first $1,400) paid to that employee by the household employer are subject to FICA taxes. The dollar threshold applies to each household employee individually, and the amount is revised annually. A household employee whose wages from a household employer do not meet or exceed the dollar threshold may not elect to pay FICA taxes.

An employer of a household employee is not required to withhold federal income taxes from wages paid to the household employee unless the employee asks the employer to withhold and the employer agrees.

An employer of a household employee will be liable for Federal Unemployment Tax Act (FUTA) taxes if the employer paid aggregate cash wages of $1,000 or more (for all household employees) in any calendar quarter in 2002 or 2003. If an employer is subject to FUTA taxes on wages paid to household employees, the tax applies only to the first $7,000 paid to each employee as wages during the year. The amount of wages on which FUTA taxes must be paid is not revised annually. Credits may apply to reduce the Federal tax. See Publication 926, *Household Employer's Tax Guide*, and Publication 15, *Circular E, Employer's Tax Guide*, for more information. Details about requirements for contributions to a state unemployment fund must be obtained from that state's unemployment tax office.

B. *Agency Under Section 3504*

An employer may designate an agent under section 3504 of the Code to withhold, report and pay Federal employment taxes required under chapters 21 (FICA), 24 (Collection of Income Tax at Source), and 25 (General Provisions of Employment Taxes and Collection of Income Taxes at Source) of Subtitle C of the Code. Under section 3504, all provisions of law (including penalties) applicable in respect of employers are applicable to the agent and remain applicable to the employer. A party seeking to be authorized to serve as an employer's agent by the IRS must follow the procedures set forth in Rev. Proc. 70–6, 1970–1 C.B. 420. The application for authorization must be submitted to the IRS in writing, and, among other things, it must include a completed Form 2678: *Employer Appointment of Agent Under Section 3504 of the Internal Revenue Code*, executed by each service recipient for whom the agent is to act. An agent authorized under Rev. Proc. 70–6 cannot perform the acts required of an employer under chapter 23 (FUTA).

Once the application is approved, the agent must file only one return for each tax return period using the agent's own employer identification number (EIN) regardless of the number of employers for whom the agent acts. Written on each return should be the statement "This return is filed under authorization granted in accordance with Section 3504 of the Internal Revenue Code". The agent must maintain records that will disclose the full wages paid to each home-care service provider on behalf of, and identified by, each service recipient employer for whom it acts.

C. *Special Procedures for State and Local Agencies Serving as Section 3504 Agents for Domestic Service Recipients*

Under Rev. Proc. 80–4, a state or local health and welfare agency is relieved of some of the procedural requirements that apply under Rev. Proc. 70–6 when it requests authorization to act as agent on behalf of participants enrolled in a state program that provides in-home domestic services and is partially funded with federal grants under Titles XIX and XX of the Social Security Act, as amended by 42 U.S.C. §§ 1396 and 1397 (1976). Rev. Proc.

80–4 provides that a state or local government agency wishing to act as a section 3504 agent for service recipients (a "state agent") may omit Form 2678 from its application package and instead, may reference in its application package a separate document the service recipient filed (or will file) with the state appointing the state to act as agent. Rev. Proc. 80–4 also provides that a state can act as agent on behalf of a service recipient for FUTA taxes, if applicable. Rev. Proc. 80–4 applies to states that furnish the home-care service providers to the service recipients.

As discussed above, household employees are subject to specific rules with respect to FICA and income tax withholding. The deposit rules for accumulated FICA taxes are established in section 31.6302–1 of the Employment Tax Regulations. As determined by an employer's lookback period defined in section 31.6302–1(b)(4), an employer may be either a monthly or semi-weekly depositor depending on whether the taxpayer exceeded $50,000 in employment taxes reported for the lookback period. An employer may also be subject to a One-Day deposit rule when amounts are accumulated in excess of $100,000. A taxpayer that exceeds a $200,000 deposit threshold is required to deposit funds electronically as provided by section 31.6302–1(h).

Section 3510 of the Code provides that employers of household employees who are not liable for employment taxes with respect to other employees should report and pay FICA, FUTA and any income tax withholding with respect to their household employees on an annual basis. Immediately after section 3510 was enacted in 1994, the Service published Notice 95–18, 1995–1 C.B. 300, to provide additional guidance to taxpayers who employ household employees. According to Q & A 5 in that notice, state agents authorized to act as agents in accordance with the procedures set forth in Rev. Proc. 80–4 are to report employment taxes for household employees quarterly on Form 941, *Employer's Quarterly Federal Tax Return*. Thus, the service recipients who employ the home-care service providers and who designate state agents do not also need to file Schedule H with their individual Form 1040 to report and pay employment taxes with respect to their home-care service providers.

Q & A 5 of Notice 95–18 also directs state agents authorized as agents in accordance with Rev. Proc. 80–4 to obtain a separate EIN (distinct from the one the state agent uses in reporting employment taxes for its own employees) for use in withholding, reporting and payment of employment taxes on behalf of all the service recipients for whom it acts as agent.

Notice 95–18 provides that state agents authorized under Rev. Proc. 80–4 should report employment taxes on behalf of the service recipients they represent quarterly on Form 941. Instead of following the deposit schedule set forth in the regulations, state agents authorized under Rev. Proc. 80–4 were permitted to remit the employment taxes with a timely filed Form 941 in 1995.

III. DEFINITIONS

Service recipient — An individual participating in an in-home domestic services program administered by a state or local agency and all or part of the services received are paid for with funds supplied by the Federal, state or local government.

Home-care service provider — A worker that provides domestic services to a service recipient under a state or local government agency in-home domestic services program funded in whole or in part with Federal, state or local funds.

State agent — A state or local agency administering an in-home domestic services program and designated as agent for the service recipient in accordance with Rev. Proc. 70–6 as modified by Rev. Proc. 80–4 and this revenue procedure.

Employment taxes — The taxes imposed on employees and employers by the Federal Insurance Contributions Act (FICA), sections 3101 and 3111 of the Code; the tax imposed on employers by the Federal Unemployment Tax Act (FUTA), section 3301 of the Code; and income tax withholding, section 3402 of the Code.

Reporting agent — an accounting service, franchiser, bank, service bureau or other entity authorized to perform one or more acts on behalf of an employer, including sign and file Forms 940 and 941 and make Federal tax deposits for the taxes reported on those forms.

Subagent — an individual or entity designated as an agent by a state agent in accordance with Rev. Proc. 70–6 and this revenue procedure.

IV. QUESTIONS AND ANSWERS

A. LIST OF QUESTIONS

Q–1. *What are the employment tax obligations of a common law employer?*

Q–2. *Can a common law employer authorize another party to perform the employment tax obligations on his or her behalf?*

Q–3. *What is the procedure to request authorization to act as agent?*

Q–4. *What can an agent authorized under section 3504 do for the employer?*

Q–5. *Who is the common law employer of the home-care service provider?*

Q–6. *Is the procedure for authorizing an agent different if a service recipient participating in an in-home domestic services program administered by a state or local government agency wants to authorize the state or local agency to serve as agent?*

Q–7. *What can a state agent authorized under section 3504 do for the service recipient?*

Q–8. *How is an authorization to act as agent terminated?*

Q–9. *What is an employer identification number (EIN)?*

Q–10. *What are the EIN requirements for a service recipient who becomes the employer of a home-care service provider?*

Q–11. *What are the EIN requirements that apply to a state agent?*

Q–12. *How should a state agent report the income tax and FICA taxes withheld and paid on the wages of home-care service providers?*

Q–13. *What are the Federal Unemployment Tax Act (FUTA) reporting requirements of a state agent acting on behalf of a service recipient?*

Q–14. *What are the deposit requirements for a state agent?*

Q–15. *What are the Form W–2, Wage and Tax Statement, rules applicable to a state agent?*

Q–16. *If a home-care service provider performed services for more than one service recipient during the year, but each service recipient has designated the same state agent, must separate W–2's be issued?*

Q–17. *May a state agent furnish a Form W–2 to a home-care service provider who earned less than the FICA threshold?*

Q–18. *Can a state agent engage a third party to perform the acts the state would be required to perform as agent?*

Q–19. *If a state agent uses a reporting agent, is the state agent relieved of liability for the employment tax?*

Q–20. *If the state agent hires a reporting agent, should the reporting agent use the special EIN obtained by the state agent to report and pay employment taxes in accordance with the instructions given in Notice 95–18?*

Q–21. *How should a reporting agent acting on behalf of a state agent report the income and FICA taxes withheld and paid on the wages of home-care service providers?*

Q–22. *How should a reporting agent acting on behalf of a state agent report FUTA tax obligations of service recipients?*

Q–23. *May a reporting agent acting on behalf of a state agent remit employment taxes with a timely filed employment tax return?*

Q–24. *What are the rules for completing Form W–2, Wage and Tax Statement, when a reporting agent prepares returns on behalf of a state agent?*

Q–25. *How can a state agent designate a subagent to perform the acts the state is required to perform as agent?*

Q–26. *Who is liable for employment taxes when a state agent uses a subagent to carry out the duties the state agent is required to fulfill as agent?*

Q–27. *When filing employment tax returns, should the subagent acting on behalf of a state agent use the special EIN the state agent obtained for use in reporting taxes of the service recipients?*

Q–28. *How should a subagent acting on behalf of a state agent report the income tax and FICA taxes withheld and paid on the wages of home-care service providers?*

Q–29. *What are the Federal Unemployment Tax Act (FUTA) reporting requirements of a subagent acting on behalf of a state agent?*

Q–30. *Is a subagent acting on behalf of a state agent eligible to remit the taxes with a timely filed return?*

Q–31. *What are the rules for completing Form W–2, Wage and Tax Statement, when a subagent acting on behalf of a state agent completes the return?*

B. Q & As RELATED TO AGENTS AND STATE AGENTS

Q–1. *What are the employment tax obligations of a common law employer?*

A–1. A common law employer generally must withhold, report, and pay Federal employment taxes with respect to wage payments made to an employee. An employer of an employee who provides domestic services in the employer's home is not required to withhold income tax with respect to the household employee's wages unless the employee has requested such treatment, and the employer has consented. Thus, service recipients are required to withhold income tax from home-care service providers only if the home-care service provider has requested withholding, and the service recipient has consented to withhold. An employer must withhold and pay FICA taxes and pay FUTA taxes, if applicable, regardless of whether income taxes are withheld.

Q–2. *Can a common law employer authorize another party to perform the employment tax obligations on his or her behalf?*

A–2. Under section 3504 of the Code, an employer may authorize an agent to perform such acts as are required of employers under the Code. In accordance with section 3504, both the designated agent and the employer who uses a designated agent are subject to the provisions of Federal tax law (including penalties) applicable to the employer with respect to employment taxes. Thus, the employer and the agent designated to fulfill the employer's duties to withhold, report, and/or pay employment taxes are both independently liable for the employment taxes.

Q–3. *What is the procedure to request authorization to act as agent?*

A–3. An agent seeking authorization should generally follow the procedure set forth in Rev. Proc. 70–6. But see Q&A 6 for state agents. The agent should forward to the Internal Revenue Service Center Director indicated on the Form 2678: (1) a written request for authority to act as agent for one or more service recipients; and (2) a completed Form 2678: *Employer Appointment of Agent Under Section 3504 of the Internal Revenue Code*, executed by each service recipient for whom the agent is to act.

Q–4. *What can an agent authorized under section 3504 do for the employer?*

A–4. An agent authorized under section 3504 can withhold, report and pay FICA taxes and income tax withholding with respect to the employer's employees. The agent may also furnish Forms W–2 to the employees.

Q–5. *Who is the common law employer of the home-care service provider?*

A–5. Generally, the service recipient is the employer of the home-care service provider if the service recipient has the right to direct and control the performance of the services. This control refers not only to the result to be accomplished by the work but also the means and details by which that result is accomplished.

Q–6. *Is the procedure for authorizing an agent different if a service recipient participating in an in-home domestic services program administered by a state or local government agency wants to authorize the state or local agency to serve as agent?*

A–6. Yes. The state or local agency needs to file a written application with the Internal Revenue Service Center Director as indicated on the Form 2678. However, state or local agencies filing applications to be designated as agents on behalf of service recipients enrolled in an in-home domestic services program administered by the agency do not need to submit a copy of Form 2678 for each service recipient. In lieu of Form 2678, the state or local agency may solicit authorization to act as agent from each service recipient in the forms the service recipient must complete in order to become enrolled in the agency's program. The state or local agency may then make reference to these forms in its application to the IRS. Details with respect to the language that must be included in the forms should be worked out between the state and the Director with whom the employment tax returns are filed. In cases in which the domestic services are provided under a state-wide uniform program, the state agency that administers the program may file one application to act as agent for all service recipients. In cases in which the programs vary by local jurisdiction, each state or local government agency that wishes to act as agent for employment tax purposes should file an application.

The Director will send a letter to each state or local government agency whose application is approved. The letter of authorization will be effective when mailed.

Q–7. *What can a state agent authorized under section 3504 do for the service recipient?*

A–7. A state agent can withhold, report and pay FICA taxes, income tax withholding (if the service recipient agrees to withhold at the request of the home-care service provider) and FUTA taxes (if applicable). The state agent may also furnish Forms W–2 to the home-care service provider.

Q–8. *How is an authorization to act as agent terminated?*

A–8. If an authorized agent wants to stop performing the agent functions for an employer, a letter to this effect should be sent to the Service Center Director that approved the application. This termination is effective when received by the Director. The Director will notify the agent by letter that the termination letter has been received. Terminations commenced by the Director are effective when mailed by the Director.

Q–9. *What is an employer identification number (EIN)?*

A–9. An EIN is a nine-digit number used by the Internal Revenue Service to identify employers. To obtain an EIN by telephone, fax, or mail, see the Instructions for Form SS–4, *Application for Employer Identification Number.* Generally, an employer should have only one EIN.

Q–10. *What are the EIN requirements for a service recipient who becomes the employer of a home-care service provider?*

A–10. As a general rule, service recipients who are employers must obtain an EIN to be used either in reporting and paying employment taxes or in completing Form 2678 to appoint another party as agent for employment tax purposes. However, service recipients who designate a state agent as agent for employment tax purposes do not report and file their own employment taxes and do not need to execute a Form 2678. Therefore, they do not need to obtain an EIN solely for the purpose of designating an agent and reporting and paying Federal employment taxes. However, the service recipient might need an EIN to satisfy the procedures for making contributions to a state unemployment fund.

Q–11. *What are the EIN requirements that apply to a state agent?*

A–11. As directed by Notice 95–18, Q & A 5, a state agent should obtain a separate EIN (in addition to the one obtained for use in reporting taxes of its own employees) for use in reporting taxes on behalf of all the service recipients for whom it acts as agent.

Q–12. *How should a state agent report the income tax and FICA taxes withheld and paid on the wages of home-care service providers?*

A–12. The state agent must file only one return for each tax return period regardless of the number of service recipients for whom it is acting as agent. Form 941 should be used to report the aggregate FICA taxes and withheld income taxes. The state agent's name and EIN are to be entered as provided by the instructions for the return. Attached to each return shall be the statement, "This return is filed under authorization granted in accordance with Section 3504 of the Internal Revenue Code." The state agent must maintain records that will show the full wages paid to each home-care service provider on behalf of, and identified by, each service recipient for whom it acts.

Q–13. *What are the Federal Unemployment Tax Act (FUTA) reporting requirements of a state agent acting on behalf of a service recipient?*

A–13. Under sections 3306(a)(3) and 3306(c)(2) of the Code, a service recipient is subject to FUTA tax only if the service recipient paid cash wages of $1,000 or more (for all household employees) in any calendar quarter of the calendar year or the preceding calendar year. The tax applies to the first $7,000 paid as wages to each employee during the year. The amount of wages on which FUTA taxes must be paid is not revised annually. Credits against FUTA tax generally are available for amounts paid into state unemployment funds. In the instances where a service recipient is liable for the FUTA tax, the agent should report and pay those taxes in addition to the FICA and withheld income tax liabilities which arise. FUTA taxes should be reported on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return.*

Using its special EIN, a state agent may file one FUTA return on behalf of all service recipients for whom it acts as agent. Attached to each return shall be the statement, "This return is filed under authorization granted in accordance with Section 3504 of the Internal Revenue Code."

Q–14. *What are the deposit requirements for a state agent?*

A–14. A state agent that withholds, reports and pays employment taxes on behalf of service recipients who employ home-care service providers is permitted to remit taxes with a timely filed return. The state agent should note its status as a state or local government agency authorized to act as a section 3504 agent for service recipients on the return, citing this revenue procedure. The note will indicate to the Service Center that any penalties for failure to deposit timely should not be assessed.

Q–15. *What are the Form W–2, Wage and Tax Statement, rules applicable to a state agent?*

A–15. A state agent must file a Form W–2 on behalf of each service recipient for (a) each home-care service provider who received an amount in cash wages equal to or greater than the dollar threshold for FICA for the year and (b) each home-care service provider who had Federal income taxes withheld. A state agent should enter its own EIN and name itself as the employer on the Form W–2. One Form W–3, *Transmittal of Wage and Tax Statement,* must be filed with all Forms W–2 filed by the agent on behalf of the service recipients. See *Instructions for Forms W–2 and W–3,* for more information.

Q–16. *If a home-care service provider performed services for more than one service recipient during the year, but each service recipient has designated the same state agent, must separate W–2's be issued?*

A–16. Yes. The state agent must furnish a separate Form W–2 for each home-care service provider on behalf of each service recipient for whom that home-care service provider provides services.

Q–17. *May a state agent furnish a Form W–2 to a home-care service provider who earned less than the FICA threshold?*

A–17. Yes. A state agent may, but is not required to, report the wages paid to a home-care service provider on Form W–2 even though no income tax was withheld, and the wages paid are less than the dollar threshold and not subject to FICA taxes. The Form W–2 is properly used to report the wages because it serves as a receipt for remuneration paid to an employee. No amount should be reported as Social Security or Medicare wages on the Form W–2, but the amount paid should be reported as Wages, tips, or other compensation.

C. Q & As RELATED TO THIRD PARTIES

Q–18. *Can a state agent engage a third party to perform the acts the state would be required to perform as agent?*

A–18. Yes, a state may either hire a reporting agent or designate a subagent to perform the obligations of an employer that accrue to the state as agent.

1. REPORTING AGENTS

Q–19. *If a state agent uses a reporting agent, is the state agent relieved of liability for the employment tax?*

A–19. No. A reporting agent assumes no liability with the Service. The state and the service recipient remain liable for any unfulfilled employment tax obligations (including penalties.)

Q–20. *If the state agent hires a reporting agent, should the reporting agent use the special EIN obtained by the state agent to report and pay employment taxes in accordance with the instructions given in Notice 95–18?*

A–20. Yes, the reporting agent should use the special EIN of the state agent.

Q–21. *How should a reporting agent acting on behalf of a state agent report the income and FICA taxes withheld and paid on the wages of home-care service providers?*

A–21. The reporting agent must file only one return for each tax return period regardless of the number of service recipients for whom the state is acting as agent. Form 941 should be used to report the aggregate FICA taxes and withheld income taxes. The state agent's name and special EIN are to be entered as provided by the instructions for the return. Attached to each return shall be the statement, "This return is filed under authorization granted in accordance with Section 3504 of the Internal Revenue Code." The reporting agent or the state agent must maintain records that will show the full wages paid to each home-care service provider on behalf of, and identified by, each service recipient for whom the state agent acts.

Q–22. *How should a reporting agent acting on behalf of a state agent report FUTA tax obligations of service recipients?*

A–22. A reporting agent should file one FUTA return using the name and special EIN of the state agent. Attached to each return shall be the statement, "This return is filed under authorization granted in accordance with Section 3504 of the Internal Revenue Code."

Q–23. *May a reporting agent acting on behalf of a state agent remit employment taxes with a timely filed employment tax return?*

A–23. Yes. Under standard principles of payroll reporting, the state agent is entitled to use a reporting agent without being subjected to a change in deposit schedules. If the state agent were filing without using a reporting agent, it would be entitled to remit employment taxes at the time of filing, rather than being required to remit taxes on a more accelerated and frequent basis. (See Q&A 14 above). The state agent that uses a reporting agent enjoys the same relief.

Q–24. *What are the rules for completing Form W–2, Wage and Tax Statement, when a reporting agent prepares returns on behalf of a state agent?*

A–24. A reporting agent should prepare Forms W–2 on behalf of home-care service providers as if it were the state agent. See Q&A 15–17 and *Instructions for Forms W–2 and W–3*, for more information.

2. SUBAGENTS

Q–25. *How can a state agent designate a subagent to perform the acts the state is required to perform as agent?*

A–25. The state or local government agency should ask the program participant to appoint the state as agent in accordance with the provisions set forth in Q&A 6 above and also to authorize the agency to appoint a subagent to assist in meeting its responsibilities as agent. The state may elect to include these requests for authorization in the forms the service recipient completes in order to enroll in the in-home domestic services program. The state agent can then designate a subagent using Form 2678. The state agent should execute the Form 2678 and provide it to the third party the state wishes to authorize as subagent. The subagent should submit the Form 2678 to the Service according to the procedures set forth in Rev. Proc. 70–6, (See Q&A 3) except that the Form should show the state agent's special EIN rather than its standard EIN.

Q–26. *Who is liable for employment taxes when a state agent uses a subagent to carry out the duties the state agent is required to fulfill as agent?*

A–26. All parties remain liable. The service recipient is liable by virtue of his or her status as common law employer. Because both the state and the subagent are designated agents acting pursuant to section 3504 of the Code, these parties are also liable.

Q–27. *When filing employment tax returns, should the subagent acting on behalf of a state agent use the special EIN the state agent obtained for use in reporting taxes of the service recipients?*

A–27. Yes. When the state executes and submits a Form 2678 authorizing a subagent to act as agent on its behalf, the state authorizes the subagent to use the special EIN when reporting and depositing taxes for the service recipients and when providing W–2s to the home-care service providers.

Q–28. *How should a subagent acting on behalf of a state agent report the income tax and FICA taxes withheld and paid on the wages of home-care service providers?*

A–28. The subagent must file only one return for each tax return period using the state agent's name and special EIN regardless of the number of employers for whom the subagent acts. Written on the return should be the statement "This return is filed under authorization granted in accordance with Section 3504 of the Internal Revenue Code". The subagent should maintain records that will show the full wages paid to each home-care service provider on behalf of, and identified by, each service recipient for whom it acts.

Q–29. *What are the Federal Unemployment Tax Act (FUTA) reporting requirements of a subagent acting on behalf of a state agent?*

A–29. A subagent should file one Form 940 using the name and special EIN of the state agent on behalf of all service recipients for whom it acts. Written on the return should be the statement "This return is filed under authorization granted in accordance with Section 3504 of the Internal Revenue Code".

Q–30. *Is a subagent acting on behalf of a state agent eligible to remit the taxes with a timely filed return?*

A–30. No. A subagent must follow the deposit schedule in section 31.6302–1 of the Employment Tax Regulations that is otherwise applicable. See Publication 15, *Circular E, Employer's Tax Guide*, for more information.

Q–31. *What are the rules for completing Form W–2, Wage and Tax Statement, when a subagent acting on behalf of a state agent completes the return?*

A–31. A subagent should prepare Forms W–2 for home-care service providers as if it were the state agent. See Q & As 15–17 and *Instructions for Forms W–2 and W–3*, for more information. However, a subagent should use the name and special EIN of the state agent instead of its own EIN.

V. EFFECTIVE DATE

This Revenue Procedure is effective on the date specified in the final version of the Revenue Procedure as published in the Federal Register.

VI. EFFECT ON OTHER PUBLICATIONS

Rev. Proc. 70–6 is modified and superseded, in part. Rev. Proc. 80–4 is modified and amplified. Notice 95–18 is modified.

VII. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure will be submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(c)).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section IV, requiring state agents, reporting agents and subagents to maintain such records as will disclose the full wages paid to each home-care service provider on behalf of, and identified by, each service recipient for whom it acts. This information is required for the agent to figure, withhold, report and pay FICA and FUTA taxes on wages of home-care service providers. This information should be used to determine whether the FICA and FUTA taxes are applicable. The collection of information is required to assure that the correct taxes are withheld, reported and paid. The likely respondents are individuals, state or local agencies and for-profit and nonprofit entities.

The estimated total annual reporting and/or recordkeeping burden is 556 hours.

The estimated annual burden per respondent/recordkeeper varies from 1 to 10 hours, depending on individual circumstances, with an estimated average of 4 hours. The estimated number of respondents and/or recordkeepers is 139.

The estimated annual frequency of responses (used for reporting requirements only) is four times per calendar year.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

VIII. DRAFTING INFORMATION

The principal author of this revenue procedure is Paul J. Carlino of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Service and Treasury Department participated in the development of this revenue procedure. For further information regarding this revenue procedure, contact Mr. Carlino at (202) 622–6040 (not a toll-free call).

Stock That is Considered Readily Tradable on an Established Securities Market in the United States for Purposes of Section 1(h)(11)(C)(ii)

Notice 2003–71

SUMMARY

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108–27, 117 Stat. 752) (the "2003 Act") was enacted on May 28, 2003. Subject to certain limitations, the 2003 Act generally provides that a dividend paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation" is subject to tax at the reduced rates applicable to certain capital gains. A qualified foreign corporation includes certain foreign corporations that are eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program. In addition, a foreign corporation not otherwise treated as a qualified foreign corporation is so treated with respect to any dividend it pays if the stock with respect to which it pays such dividend is readily tradable on an established securities market in the United States. This notice defines, for taxable years beginning on or after January 1, 2003, what it means to be readily tradable on an established securities market in the United States. Treasury and the IRS intend to issue regulations under section 1(h) incorporating the principles outlined in this notice. This notice also requests comment on possible expansion of this definition for future taxable years.

ANALYSIS

Section 1(h)(1) of the Code generally provides that a taxpayer's "net capital gain" for any taxable year will be subject to a maximum tax rate of 15 percent (or 5 percent in the case of certain taxpayers). The 2003 Act added section 1(h)(11), which provides that net capital gain for purposes of section (1)(h) means net capital gain (determined without regard to section 1(h)(11)) increased by "qualified dividend income". Qualified dividend income means dividends received during the taxable year from domestic corporations and "qualified foreign corporations". Section 1(h)(11)(B)(i). Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either (i) incorporated in a possession of the United States, or (ii) eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program.[1] Section 1(h)(11)(C)(i). Subject to the same exceptions, a foreign corporation that does not satisfy either of these two tests is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States. Section 1(h)(11)(C)(ii). A qualified foreign corporation does not include any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a foreign personal holding company (as defined in section 552), a foreign investment company (as defined in section 1246(b)), or a passive foreign investment company (as defined in section 1297).[2] Section 1(h)(11)(C)(iii).

For purposes of applying section 1(h)(11)(C)(ii) to taxable years beginning on or after January 1, 2003, common or ordinary stock, or an American depositary receipt in respect of such stock, is considered readily tradable on an established securities market in the United States if it is listed on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) or on the Nasdaq Stock Market. As stated in the SEC's Annual Report for 2002, registered national exchanges as of September 30, 2002, include the American Stock Exchange, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Chicago Stock Exchange, the NYSE, the Philadelphia Stock Exchange, and the Pacific Exchange, Inc.

Treasury and the IRS are continuing to consider, for future years, the treatment of dividends with respect to stock listed only in a manner that does not meet this definition, such as on the OTC Bulletin Board or on the electronic pink sheets. In particular, Treasury and the IRS are considering whether or to what extent treatment of stock that is listed only in such manner as "readily tradable on an established securities market in the United States" should be conditioned on the satisfaction of parameters regarding minimum trading volume, minimum number of market makers, maintenance and publication of historical trade or quotation data, issuer reporting requirements under SEC or exchange rules, or issuer disclosure or determinations regarding passive foreign investment company, foreign investment company, or foreign personal holding company status. Treasury and the IRS request comments on the treatment of such stock and on the use of these parameters or any other factors that commentators believe should be considered.

EFFECTIVE DATE

This notice is effective for taxable years beginning on or after January 1, 2003.

COMMENTS

Treasury and the IRS invite interested persons to comment on the issues raised in this notice with regard to future years. Written comments may be submitted to CC:ITA:RU (Notice 2003–71), room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 5 pm to: CC:ITA:RU (Notice 2003–71), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044. Alternatively, taxpayers may submit comments electronically via the following e-mail address: *Notice.Comments@irscounsel.treas.gov.* Please include "Notice 2003–71" in the subject line of any electronic communications.

CONTACT INFORMATION

The principal author of this notice is Karen Rennie-Quarrie of the Office of Associate Chief Counsel (International). Ms. Rennie-Quarrie may be contacted at (202) 622–3880 (not a toll-free number).

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26 CFR 601.702: Publication, public inspection and specific requests for records.
(Also, sections 6103, 6104; 301.6103; 301.6104.)

Rev. Proc. 2003–74

SECTION 1. PURPOSE

This revenue procedure revokes Rev. Proc. 66–3, 1966–1 C.B. 601, Rev. Proc. 84–71, 1984–2 C.B. 735, Rev. Proc. 85–56, 1985–2 C.B. 739, Rev. Proc. 87–21, 1987–1 C.B. 718, Rev. Proc. 94–52, 1994–2 C.B. 712, and Rev. Proc. 97–11, 1997–1 C.B. 630, which describe procedures previously used by the Internal Revenue Service (IRS) for providing copies of returns and return information pursuant to sections 6103 and 6104 of the Internal Revenue Code (Code). These procedures have been superseded by current IRS practices. The current procedures are described in section 601.702(d)(1), (3), (4), and (5) of the Statement of Procedural Rules and on the forms used to request copies or inspection of returns and return information.

SECTION 2. BACKGROUND

.01 Under section 6103(e)(1) through (6), a person with a material interest in a tax return may inspect that return. Under section 6103(e)(7), a person who may inspect a return under section 6103(e)(1) through (6) may inspect return information pertaining to that return if the Secretary determines that disclosure of the return information would not seriously impair Federal tax administration. Under section 6103(p)(2), the Secretary is authorized to furnish copies to any person authorized to inspect returns and return information and to charge a reasonable fee for the copies. See also section 601.702(d)(1) of the Statement of Procedural Rules.

.02 Section 6104(a), (b), and (d) requires the IRS to make available for public inspection certain returns and return information including applications, notices, and reports relating to certain tax exempt organizations and pension plans.

.03 Section 301.6104(a)–6 of the Procedure and Administration Regulations and

[1] Notice 2003–69 contains the current list of the U.S. tax treaties that meet these requirements.

[2] A dividend from a qualified foreign corporation also is subject to the other limitations in section 1(h)(11). For example, a shareholder receiving a dividend from a qualified foreign corporation must satisfy the holding period requirements of section 1(h)(11)(B)(iii).

section 601.702(d)(1), (3), (4), and (5) of the Statement of Procedural Rules provide procedures to inspect or obtain copies of certain exempt organization or pension plan returns and return information that are publicly available and authority for any fees for copies.

SECTION 3. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 66–3 is revoked.
Rev. Proc. 84–71 is revoked.
Rev. Proc. 85–56 is revoked.
Rev. Proc. 87–21 is revoked.
Rev. Proc. 94–52 is revoked.
Rev. Proc. 97–11 is revoked.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective October 27, 2003.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Sarah Tate of the Office of the Associate Chief Counsel, Procedure and Administration (Disclosure and Privacy Law Division). For further information regarding this revenue procedure, contact Sarah Tate at (202) 622–4590 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 62, 162, 170, 213, 217, 274, 1016; 1.62–2, 1.162–17, 1.170A–1, 1.213–1, 1.217–2, 1.274–5, 1.1016–3.)

Rev. Proc. 2003–76

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2002–61, 2002–2 C.B. 616, by providing optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under § 1.274–5 of the Income Tax Regulations if a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. Use of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation.

SECTION 2. SUMMARY OF STANDARD MILEAGE RATES

.01 *Standard mileage rates*.

(1) Business (section 5 below)	37.5 cents per mile
(2) Charitable (section 7 below)	14 cents per mile
(3) Medical and moving (section 7 below)	14 cents per mile

.02 *Determination of standard mileage rates*. The business, medical, and moving standard mileage rates reflected in this revenue procedure are based on an annual study of the fixed and variable costs of operating an automobile conducted on behalf of the Internal Revenue Service by an independent contractor, and the charitable standard mileage rate is provided in § 170(i) of the Internal Revenue Code.

SECTION 3. BACKGROUND AND CHANGES

.01 Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct the cost of operating an automobile to the extent that it is used in a trade or business. However, under § 262, no portion of the cost of operating an automobile that is attributable to personal use is deductible.

.02 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 with respect to any listed property (as defined in § 280F(d)(4) to include passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. Section 274(d) further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by the regulations.

.03 Section 1.274–5(j), in part, grants the Commissioner of Internal Revenue the authority to establish a method under which a taxpayer may use mileage rates to substantiate, for purposes of § 274(d), the amount of the ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home.

.04 Section 1.274–5(g), in part, grants the Commissioner the authority to prescribe rules relating to mileage allowances for ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which the allowances, if in accordance with reasonable business practice, will be regarded as (1) equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of the travel and transportation expenses for purposes of § 1.274–5(c), and (2) satisfying the requirements of an adequate accounting to the employer of the amount of the expenses for purposes of § 1.274–5(f).

.05 Section 62(a)(2)(A) allows an employee, in determining adjusted gross income, a deduction for the expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement. Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for the expense.

.07 Under § 1.62–2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62–2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274–5(g) will be treated as substantiation of the amount of the expenses for purposes of § 1.62–2. Under § 1.62–2(f)(2), the Commissioner may prescribe rules under which an arrangement providing mileage allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of the allowance that relates to miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of the allowance that relates to miles of travel not substantiated.

.08 Section 1.62–2(h)(2)(i)(B) provides that if a payor pays a mileage allowance under an arrangement that meets the requirements of § 1.62–2(c)(1), the portion, if any, of the allowance that relates to miles of travel substantiated in accordance with § 1.62–2(e), that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under § 274(d) and § 1.274–5(g), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)–3, 31.3231(e)–1(a)(5), 31.3306(b)–2, and 31.3401(a)–4 of the Employment Tax Regulations. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62–2(g) (relating to the return of excess amounts) do not apply to this excess portion.

.09 Under § 1.62–2(h)(2)(i)(B)(4), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

.10 Section 5.06(1) of this revenue procedure revises the limitation on simultaneous use of multiple automobiles to allow a taxpayer using up to four vehicles simultaneously to use the standard mileage rate.

SECTION 4. DEFINITIONS

.01 *Standard mileage rate*. The term "standard mileage rate" means the applicable amount provided by the Service for optional use by employees or self-employed individuals in computing the deductible costs of operating automobiles (including vans, pickups, or panel trucks) they own or lease for business purposes, or by taxpayers in computing the deductible costs of operating automobiles for charitable, medical, or moving expense purposes.

.02 *Transportation expenses*. The term "transportation expenses" means the expenses of operating an automobile for local travel or transportation away from home.

.03 *Mileage allowance*. The term "mileage allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62–2(c)(1) and that is:

(1) paid with respect to the ordinary and necessary business expenses incurred, or that the payor reasonably anticipates will be incurred, by an employee for transportation expenses in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at the applicable standard mileage rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.04 *Flat rate or stated schedule*. A mileage allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 4.03 of this revenue procedure. The allowance may be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, at a rate that combines any of these rates, or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, a periodic payment at a fixed rate to cover the fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving an automobile in connection with the performance of services as an employee of the employer, coupled with a periodic payment at a cents-per-mile rate to cover the operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of using an automobile for those purposes, is an allowance paid at a flat rate or stated schedule. Likewise, a periodic payment at a variable rate based on a stated schedule for different locales to cover the costs of driving an automobile in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

SECTION 5. BUSINESS STANDARD MILEAGE RATE

.01 *In general*. The standard mileage rate for transportation expenses is 37.5 cents per mile for all miles of use for business purposes. The Service will adjust the business standard mileage rate (to the extent warranted) annually and prospectively.

.02 *Use of the business standard mileage rate*. A taxpayer may use the business standard mileage rate with respect to an automobile that is either owned or leased by the taxpayer. A taxpayer generally may deduct an amount equal to either the business standard mileage rate times the number of business miles traveled or the actual costs (both operating and fixed) paid or incurred by the taxpayer that are allocable to traveling those business miles.

.03 *Business standard mileage rate in lieu of operating and fixed costs*. A deduction using the standard mileage rate for business miles is computed on a yearly basis and is in lieu of all operating and fixed costs of the automobile allocable to business purposes (except as provided in section 9.06 of this revenue procedure). Items such as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees are included in operating and fixed costs for this purpose.

.04 *Parking fees, tolls, interest, and taxes*. Parking fees and tolls attributable to use of the automobile for business purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local personal property taxes may be deducted as separate items, but only to the extent allowable under §§ 163 or 164, respectively. Section 163(h)(2)(A) expressly provides that interest is nondeductible personal interest if it is paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee. Section 164 expressly provides that state and local taxes that are paid or accrued by a taxpayer in connection with an acquisition or disposition of property will be treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition of the property. If the automobile is operated less than 100 percent for business purposes, an allocation is required to determine the business and nonbusiness portion of the taxes and interest deduction allowable.

.05 *Depreciation*. For owned automobiles placed in service for business purposes, and for which the business standard mileage rate has been used for any year, depreciation will be considered to have been allowed at the rate of 14 cents per mile for 2000, 15 cents per mile for 2001 and 2002, and 16 cents per mile for 2003 and 2004, for those years in which the business standard mileage rate was used. If actual costs were used for one or more of those years, the rates above will not apply to any year in which the costs were used. The depreciation described above will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016.

.06 *Limitations*.

(1) The business standard mileage rate may not be used to compute the deductible expenses of (a) automobiles used for hire, such as taxicabs, or (b) five or more automobiles owned or leased by a taxpayer and used simultaneously (such as in fleet operations).

(2) The business standard mileage rate may not be used to compute the deductible business expenses of an automobile leased by a taxpayer unless the taxpayer uses either the business standard mileage rate or a FAVR allowance (as provided in section 8 of this revenue procedure) to compute the deductible business expenses of the automobile for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(3) The business standard mileage rate may not be used to compute the deductible expenses of an automobile for which the taxpayer has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, or (c) used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile (if owned) from MACRS pursuant to § 168(f)(1). If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(4) The business standard mileage rate and this revenue procedure may not be used to compute the amount of the deductible automobile expenses of an employee of the United States Postal Service incurred in performing services involving the collection and delivery of mail on a rural route if the employee receives qualified reimbursements (as defined in § 162(o)) for the expenses. *See* § 162(o) for the rules that apply to these qualified reimbursements.

SECTION 6. RESERVED

SECTION 7. CHARITABLE, MEDICAL, AND MOVING STANDARD MILEAGE RATE

.01 *Charitable*. Section 170(i) provides a standard mileage rate of 14 cents per mile for purposes of computing the charitable deduction for use of an automobile in connection with rendering gratuitous services to a charitable organization under § 170.

.02 *Medical and moving*. The standard mileage rate is 14 cents per mile for use of an automobile (a) to obtain medical care described in § 213, or (b) as part of a move for which the expenses are deductible under § 217. The Service will adjust the medical and moving expense standard mileage rates (to the extent warranted) annually and prospectively.

.03 *Charitable, medical, or moving expense standard mileage rate in lieu of operating expenses*. A deduction computed using the applicable standard mileage rate for charitable, medical, or moving expense miles is in lieu of all operating expenses (including gasoline and oil) of the automobile allocable to those purposes. Costs for items such as depreciation (or lease payments), insurance, and license and registration fees are not deductible, and are not included in the standard mileage rates.

.04 *Parking fees, tolls, interest, and taxes*. Parking fees and tolls attributable to the use of the automobile for charitable, medical, or moving expense purposes may be deducted as separate items. Interest relating to the purchase of the automobile and state and local personal property taxes are not deductible as charitable, medical, or moving expenses, but they may be deducted as separate items to the extent allowable under §§ 163 or 164, respectively.

SECTION 8. FIXED AND VARIABLE RATE ALLOWANCE

.01 *In general*.

(1) The ordinary and necessary expenses paid or incurred by an employee in driving an automobile owned or leased by the employee in connection with the performance of services as an employee of the employer will be deemed substantiated (in an amount determined under section 9 of this revenue procedure) when a payor reimburses those expenses with a mileage allowance using a flat rate or stated schedule that combines periodic fixed and variable rate payments that meet all the requirements of section 8 of this revenue procedure (a FAVR allowance).

(2) The amount of a FAVR allowance must be based on data that (a) is derived from the base locality, (b) reflects retail prices paid by consumers, and (c) is reasonable and statistically defensible in approximating the actual expenses employees receiving the allowance would incur as owners of the standard automobile.

.02 *Definitions*.

(1) *FAVR allowance*. A FAVR allowance includes periodic fixed payments and periodic variable payments. A payor may maintain more than one FAVR allowance. A FAVR allowance that uses the same payor, standard automobile (or an automobile of the same make and model that is comparably equipped), retention period, and business use percentage is considered one FAVR allowance, even though other features of the allowance may vary. A FAVR allowance also includes any optional high mileage payments; however, optional high mileage payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes when paid. See section 9.05 of this revenue procedure. An optional high mileage payment covers the additional depreciation for a standard automobile attributable to business miles driven and substantiated by the employee for a calendar year in excess of the annual business mileage for that year. If an employee is covered by the FAVR allowance for less than the entire calendar year, the annual business mileage may be prorated on a monthly basis for purposes of the preceding sentence.

(2) *Periodic fixed payment*. A periodic fixed payment covers the projected fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving the standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. A periodic fixed payment may be computed by (a) dividing the total projected fixed costs of the standard automobile for all years of the retention period, determined at the beginning of the retention period, by the number of periodic fixed payments in the retention period, and (b) multiplying the resulting amount by the business use percentage.

(3) *Periodic variable payment*. A periodic variable payment covers the projected operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. The rate of a periodic variable payment for a computation period may be computed by dividing the total projected operating costs for the standard automobile for the computation period, determined at the beginning of the computation period, by the computation period mileage. A computation period can be any period of a year or less. Computation period mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a computation period and equals the retention mileage divided by the number of computation periods in the retention period. For each business mile substantiated by the employee for the computation period, the periodic variable payment must be paid at a rate that does not exceed the rate for that computation period.

(4) *Base locality*. A base locality is the particular geographic locality or region of the United States in which the costs of driving an automobile in connection with the performance of services as an employee of the employer are generally paid or incurred by the employee. Thus, for purposes of determining the amount of fixed costs, the base locality is generally the geographic locality or region in which the employee resides. For purposes of determining the amount of operating costs, the base locality is generally the geographic locality or region in which the employee drives the automobile in connection with the performance of services as an employee of the employer.

(5) *Standard automobile*. A standard automobile is the automobile selected by the payor on which a specific FAVR allowance is based.

(6) *Standard automobile cost*. The standard automobile cost for a calendar year may not exceed 95 percent of the sum of (a) the retail dealer invoice cost of the standard automobile in the base locality, and (b) state and local sales or use taxes applicable on the purchase of the automobile. Further, the standard automobile cost may not exceed $28,100.

(7) *Annual mileage*. Annual mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a calendar year. Annual mileage equals the annual business mileage divided by the business use percentage.

(8) *Annual business mileage*. Annual business mileage is the mileage a payor reasonably projects a standard automobile will be driven by an employee in connection with the performance of services as an employee of the employer during the calendar year, but may not be less than 6,250 miles for a calendar year. Annual business mileage equals the annual mileage multiplied by the business use percentage.

(9) *Business use percentage*. A business use percentage is determined by dividing the annual business mileage by the annual mileage. The business use percentage may not exceed 75 percent. In lieu of demonstrating the reasonableness of the business use percentage based on records of total mileage and business mileage driven by the employees annually, a payor may use a business use percentage that is less than or equal to the following percentages for a FAVR allowance that is paid for the following annual business mileage:

Annual business mileage	*Business use percentage*
6,250 or more but less than 10,000	45 percent
10,000 or more but less than 15,000	55 percent
15,000 or more but less than 20,000	65 percent
20,000 or more	75 percent

(10) *Retention period*. A retention period is the period in calendar years selected by the payor during which the payor expects an employee to drive a standard automobile in connection with the performance of services as an employee of the employer before the automobile is replaced. The period may not be less than two calendar years.

(11) *Retention mileage*. Retention mileage is the annual mileage multiplied by the number of calendar years in the retention period.

(12) *Residual value*. The residual value of a standard automobile is the projected amount for which it could be sold at the end of the retention period after being driven the retention mileage. The Service will accept the following safe harbor residual values for a standard automobile computed as a percentage of the standard automobile cost:

Retention period	*Residual value*
2-year	70 percent
3-year	60 percent
4-year	50 percent

.03 *FAVR allowance in lieu of operating and fixed costs*.

(1) A reimbursement computed using a FAVR allowance is in lieu of the employee's deduction of all the operating and fixed costs paid or incurred by an employee in driving the automobile in connection with the performance of services as an employee of the employer, except as provided in section 9.06 of this revenue procedure. Items such as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, license and registration fees, and personal property taxes are included in operating and fixed costs for this purpose.

(2) Parking fees and tolls attributable to an employee driving the standard automobile in connection with the performance of services as an employee of the employer are not included in fixed and operating costs and may be deducted as separate items. Similarly, interest relating to the purchase of the standard automobile may be deducted as a separate item, but only to the extent that the interest is an allowable deduction under § 163.

.04 *Depreciation*.

(1) A FAVR allowance may not be paid with respect to an automobile for which the employee has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, or (c) used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. If an employee uses actual costs for an owned automobile that has been covered by a FAVR allowance, the employee must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(2) Except as provided in section 8.04(3) of this revenue procedure, the total amount of the depreciation component for the retention period taken into account in computing the periodic fixed payments for that retention period may not exceed the excess of the standard automobile cost over the residual value of the standard automobile. In addition, the total amount of the depreciation component may not exceed the sum of the annual § 280F limitations on depreciation (in effect at the beginning of the retention period) that apply to the standard automobile during the retention period.

(3) If the depreciation component of periodic fixed payments exceeds the limitations in section 8.04(2) of this revenue procedure, that section will be treated as satisfied in any year during which the total annual amount of the periodic fixed payments and the periodic variable payments made to an employee driving 80 percent of the annual business mileage of the standard automobile does not exceed the amount obtained by multiplying 80 percent of the annual business mileage of the standard automobile by the applicable business standard mileage rate for that year (under section 5.01 of the applicable revenue procedure).

(4) The depreciation included in each periodic fixed payment portion of a FAVR allowance paid with respect to an automobile will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016. See section 8.07(2) of this revenue procedure for the requirement that the employer report the depreciation component of a periodic fixed payment to the employee.

.05 *FAVR allowance limitations*.

(1) A FAVR allowance may be paid only to an employee who substantiates to the payor for a calendar year at least 5,000 miles driven in connection with the performance of services as an employee of the employer or, if greater, 80 percent of the annual business mileage of that FAVR allowance. If the employee is covered by the FAVR allowance for less than the entire calendar year, these limits may be prorated on a monthly basis.

(2) A FAVR allowance may not be paid to a control employee (as defined in § 1.61–21(f)(5) and (6), excluding the $100,000 limitation in paragraph (f)(5)(iii)).

(3) An employer may not pay a FAVR allowance if at any time during a calendar year a majority of the employees covered by the FAVR allowance are management employees.

(4) An employer may not pay a FAVR allowance unless at all times during a calendar year at least five employees of the employer are covered by one or more FAVR allowances.

(5) A FAVR allowance may be paid only with respect to an automobile (a) owned or leased by the employee receiving the payment, (b) the cost of which, when new, is at least 90 percent of the standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance with respect to that automobile, and (c) the model year of which does not differ from the current calendar year by more than the number of years in the retention period.

(6) A FAVR allowance may not be paid with respect to an automobile leased by an employee for which the employee has used actual expenses to compute the deductible business expenses of the automobile for any year during the entire lease period. For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(7) The insurance cost component of a FAVR allowance must be based on the rates charged in the base locality for insurance coverage on the standard automobile during the current calendar year without taking into account rate-increasing factors such as poor driving records or young drivers.

(8) A FAVR allowance may be paid only to an employee whose insurance coverage limits on the automobile with respect to which the FAVR allowance is paid are at least equal to the insurance coverage limits used to compute the periodic fixed payment under that FAVR allowance.

.06 *Employee reporting*. Within 30 days after an employee's automobile is initially covered by a FAVR allowance, or is again covered by a FAVR allowance if coverage has lapsed, the employee by written declaration must provide the payor with the following information: (a) the make, model, and year of the employee's automobile, (b) written proof of the insurance coverage limits on the automobile, (c) the odometer reading of the automobile, (d) if owned, the purchase price of the automobile or, if leased, the price at which the automobile is ordinarily sold by retailers (the gross capitalized cost of the automobile), and (e) if owned, whether the employee has claimed depreciation with respect to the automobile using any of the depreciation methods prohibited by section 8.04(1) of this revenue procedure or, if leased, whether the employee has computed deductible business expenses with respect to the automobile using actual expenses. The information described in (a), (b), and (c) of the preceding sentence also must be supplied by the employee to the payor within 30 days after the beginning of each calendar year that the employee's automobile is covered by a FAVR allowance.

.07 *Payor recordkeeping and reporting*.

(1) The payor or its agent must maintain written records setting forth (a) the statistical data and projections on which the FAVR allowance payments are based, and (b) the information provided by the employees pursuant to section 8.06 of this revenue procedure.

(2) Within 30 days of the end of each calendar year, the employer must provide each employee covered by a FAVR allowance during that year with a statement that, for automobile owners, lists the amount of depreciation included in each periodic fixed payment portion of the FAVR allowance paid during that calendar year and explains that by receiving a FAVR allowance the employee has elected to exclude the automobile from MACRS pursuant to § 168(f)(1). For automobile lessees, the statement must explain that by receiving the FAVR allowance the employee may not compute the deductible business expenses of the automobile using actual expenses for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

.08 *Failure to meet section 8 requirements*. If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 8 of this revenue procedure, the employee may not be treated as covered by any FAVR allowance of the payor during the period of the failure. Nevertheless, the expenses to which that mileage allowance relates may be deemed substantiated using the method described in sections 5, 9.01(1), and 9.02 of this revenue procedure to the extent the requirements of those sections are met.

SECTION 9. APPLICATION

.01 If a payor pays a mileage allowance in lieu of reimbursing actual transportation expenses incurred or to be incurred by an employee, the amount of the expenses that is deemed substantiated to the payor is either:

(1) for any mileage allowance other than a FAVR allowance, the lesser of the amount paid under the mileage allowance or the applicable standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee; or

(2) for a FAVR allowance, the amount paid under the FAVR allowance less the sum of (a) any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the payor although required to do so, (b) any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return to the payor although required to do so, and (c) any optional high mileage payments.

.02 If the amount of transportation expenses is deemed substantiated under the rules provided in section 9.01 of this revenue procedure, and the employee actually substantiates to the payor the elements of time, place (or use), and business purpose of the transportation expenses in accordance with paragraphs (b)(2) (travel away from home), (b)(6) (listed property, which includes passenger automobiles and any other property used as a means of transportation), and (c) of § 1.274–5, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5(f), as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5(c). See

§ 1.62–2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.03 An arrangement providing mileage allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) with respect to returning amounts in excess of expenses as follows:

(1) For a mileage allowance other than a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of the allowance that relates to miles of travel not substantiated by the employee, even though the arrangement does not require the employee to return the portion of the allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance mileage allowance of $80 based on an anticipated 200 business miles at 40 cents per mile (at a time when the applicable business standard mileage rate is 37.5 cents per mile), and the employee substantiates 120 business miles. The requirement to return excess amounts will be treated as satisfied if the employee is required to return the portion of the allowance that relates to the 80 unsubstantiated business miles ($32) even though the employee is not required to return the portion of the allowance ($3) that exceeds the amount of the employee's expenses deemed substantiated under section 9.01 of this revenue procedure ($45) for the 120 substantiated business miles. However, the $3 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 9.05.

(2) For a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)), (a) the portion (if any) of the periodic variable payment received that relates to miles in excess of the business miles substantiated by the employee, and (b) the portion (if any) of a periodic fixed payment that relates to a period during which the employee was not covered by the FAVR allowance.

.04 An employee is not required to include in gross income the portion of a mileage allowance received from a payor that is less than or equal to the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02. *See* § 1.274–5(f)(2)(i). In addition, that portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W–2, and is exempt from withholding and payment of employment taxes. *See* §§ 1.62–2(c)(2) and (c)(4).

.05 An employee is required to include in gross income only the portion of a mileage allowance received from a payor that exceeds the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02 of this revenue procedure. *See* § 1.274–5(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. *See* §§ 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.06 *Substantiated expenses less than employee's expenses*.

(1) Except as otherwise provided in section 9.06(2) of this revenue procedure with respect to leased automobiles, if the amount of the expenses deemed substantiated under the rules provided in section 9.01 of this revenue procedure is less than the amount of the employee's business transportation expenses, the employee may claim an itemized deduction for the amount by which the business transportation expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business transportation expenses, includes on Form 2106, *Employee Business Expenses*, the deemed substantiated portion of the mileage allowance received from the payor, and includes in gross income the portion (if any) of the mileage allowance received from the payor that exceeds the amount deemed substantiated. *See* § 1.274–5(f)(2)(iii). However, for purposes of claiming this itemized deduction, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the applicable standard mileage rate multiplied by the number of business miles substantiated by the employee minus the amount deemed substantiated under section 9.01 of this revenue procedure. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

(2) An employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(1) of this revenue procedure (relating to an allowance other than a FAVR allowance) may not claim a deduction based on actual expenses unless the employee does so consistently beginning with the first business use of the automobile after December 31, 1997. However, an employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(2) of this revenue procedure (relating to a FAVR allowance) may not claim a deduction based on actual expenses.

.07 An employee may deduct an amount computed pursuant to section 5.01 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.08 A self-employed individual may deduct an amount computed pursuant to section 5.01 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

.09 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, the payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes. *See* §§ 1.62–2(c)(3), (c)(5), and (h)(2).

SECTION 10. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a mileage allowance (other than a FAVR allowance), if any, that relates to the miles of business travel substantiated and that exceeds the amount deemed substantiated for those miles under section 9.01(1) of this revenue procedure is subject to withholding and payment of employment taxes. *See* § 1.62–2(h)(2)(i)(B).

(1) In the case of a mileage allowance paid as a reimbursement, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the business miles substantiated. *See* § 1.62–2(h)(2)(i)(B)(2).

(2) In the case of a mileage allowance paid as an advance, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the business miles with respect to which the advance was paid are substantiated. *See* § 1.62–2(h)(2)(i)(B)(3). If some or all of the business miles with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those miles within a reasonable period of time, the portion of the allowance that relates to those miles is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. *See* § 1.62–2(h)(2)(i)(A).

(3) In the case of a mileage allowance that is not computed on the basis of a fixed amount per mile of travel (for example, a mileage allowance that combines periodic fixed and variable rate payments, but that does not satisfy the requirements of section 8 of this revenue procedure), the payor must compute periodically (no less frequently than quarterly) the amount, if any, that exceeds the amount deemed substantiated under section 9.01(1) of this revenue procedure by comparing the total mileage allowance paid for the period to the applicable standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee for the period. Any excess is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. *See* § 1.62–2(h)(2)(i)(B)(4).

(4) For example, assume an employer pays its employees a mileage allowance at a rate of 40 cents per mile (when the business standard mileage rate is 37.5 cents per mile). The employer does not require the return of the portion of the allowance that exceeds the business standard mileage rate for the business miles substantiated (2.5 cents). In June, the employer advances an employee $200 for 500 miles to be traveled during the month. In July, the employee substantiates to the employer 400 business miles traveled in June and returns $40 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is $150 and the employee is not required to return $10. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on $10.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 9.01(2) of this revenue procedure is subject to withholding and payment of employment taxes. *See* § 1.62–2(h)(2)(i)(B).

(1) Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return within a reasonable period, or any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return within a reasonable period, is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. *See* § 1.62–2(h)(2)(i)(A).

(2) Any optional high mileage payment is subject to withholding and payment of employment taxes when paid.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–61, 2002–2 C.B. 616, is superseded for mileage allowances that are paid both (1) to an employee on or after January 1, 2004, and (2) with respect to transportation expenses paid or incurred by the employee on or after January 1, 2004. Rev. Proc. 2002–61 is also superseded for purposes of computing the amount allowable as a deduction for transportation expenses paid or incurred on or after January 1, 2004.

DRAFTING INFORMATION

The principal author of this revenue procedure is Christian Wood of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Wood at (202) 622–4930 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Limitation on Use of the Nonaccrual-Experience Method of Accounting Under Section 448(d)(5)

REG–141402–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9090) relating to the use of the nonaccrual-experience method of accounting by taxpayers using an accrual method of accounting and performing services. The text of those regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by December 3, 2003. Outlines of topics to be discussed at the public hearing scheduled for December 10, 2003, at 10 a.m. must be received by November 19, 2003.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–141402–02), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–141402–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *http://www.irs.gov/regs.* The public hearing will be held in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Terrance McWhorter, 202–622–4970; concerning submissions of comments, Treena Garrett, 202–622–3401 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 3, 2003. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in §1.448–2T. This information is required to verify that an alternative nonaccrual-experience method of accounting selected and used by a taxpayer to compute the amount of its otherwise accruable income that will not be collected will, based on the taxpayer's experience, accurately reflect the amount of income that the taxpayer will not collect and will clearly reflect the taxpayer's experience under section 448(d)(5) of the Internal Revenue Code. The collection of information is mandatory. The likely recordkeepers are business or other for-profit institutions, and small businesses or organizations.

Estimated total annual recordkeeping burden: 24,000 hours.

The estimated annual burden per recordkeeper varies from 1 to 5 hours, depending on individual circumstances, with an estimated average of 3 hours.

Estimated number of recordkeepers: 8,000.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background and Explanation of Provisions

Section 448(d)(5) was added to the Code by section 801 of the Tax Reform Act of 1986 (Public Law 99–514, 100 Stat. 2085) and was amended by section 403 of the Job Creation and Worker Assistance Act of 2002 (Public Law 107–147, 116 Stat. 21) (the 2002 Act), effective for taxable years ending after March 9, 2002. Temporary regulations in this issue of the Bulletin revise §1.448–2T of part 1 of title 26 of the Code of Federal Regulations. Those regulations pertain to the nonaccrual of certain amounts by taxpayers using an accrual method of accounting and performing services. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments and these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that, as previously noted, the estimated burden associated with the information collection averages three hours per respondent. Moreover, for taxpayers who are eligible to use these regulations and who follow these regulations, any burden imposed on taxpayers due to the collection of information in these regulations will be outweighed by the benefit taxpayers will receive by accruing less income than otherwise would be required. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 10, 2003, beginning at 10 a.m. in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 19, 2003.

A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Terrance McWhorter, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.448–2 is added as follows:

§1.448–2 Nonaccrual of certain amounts by service providers.

[The text of proposed §1.448–2 is the same as the text of §1.448–2T published elsewhere in this issue of the Bulletin.]

Judith B. Tomaso,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on September 3, 2003, 8:45 a.m., and published in the issue of the Federal Register for September 4, 2003, 68 F.R. 52543)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group

REG–132760–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9089) that govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments must be received by December 3, 2003.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–132760–03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–132760–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Amber Renee Cook or Marie C. Milnes-Vasquez at (202) 622–7530; concerning submission of comments, Treena Garrett at (202) 622–3401 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations (T.D. 9089) in this issue of the Bulletin amend the Income Tax Regulations (26 CFR 1) relating to section 1502. The temporary regulations govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Further, it is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

Various personnel from the IRS and Treasury Department participated in the development of these regulations.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1502–28 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–19 is amended as follows:

1. Paragraph (b)(1) is revised.

2. The headings for paragraphs (h)(2) and (h)(2)(i) are revised.

3. Paragraph (h)(2)(ii) is redesignated as paragraph (h)(2)(iii).

4. New paragraph (h)(2)(ii) is added.

The revisions and addition read as follows:

§1.1502–19 Excess loss accounts.

[The text of this proposed section is the same as the text of §1.1502–19T published elsewhere in this issue of the Bulletin].

Par. 3. Section 1.1502–21 is amended as follows:

1. Paragraphs (b)(2)(iv) and (c)(2)(vii) are revised.

2. Paragraph (h)(6) is redesignated as paragraph (h)(7).

3. New paragraph (h)(6) is added.

4. New paragraph (h)(8) is added.

The revision and additions read as follows:

§1.1502–21 Net operating losses.

[The text of this proposed section is the same as the text of §1.1502–21T published elsewhere in this issue of the Bulletin].

Par. 4. Section 1.1502–28 is added to read as follows:

§1.1502–28 Consolidated section 108.

[The text of this proposed section is the same as the text of §1.1502–28T published elsewhere in this issue of the Bulletin].

Par. 5. Section 1.1502–32 is amended as follows:

1. Paragraphs (b)(3)(ii)(C)(*1*) and (b)(3)(iii)(A) are revised.

2. Paragraph (b)(4)(vii) is added.

3. Paragraph (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) are revised.

4. Paragraph (h)(7) is added.

The revisions and additions read as follows:

§1.1502–32 Investment adjustments.

[The text of this proposed section is the same as the text of §1.1502–32T published elsewhere in this issue of the Bulletin].

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 29, 2003, 3:14 p.m., and published in the issue of the Federal Register for September 4, 2003, 68 F.R. 52542)

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2003–64

The names of organizations that no longer qualify as organizations described in section 170(c)(2) of the Internal Revenue Code of 1986 are listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on November 5, 2001, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Steve Brashen Foundation
Bellevue, WA
Clove Hitch Foundation, Inc.
Pompano Beach, FL
Spring Assistance for Educators
Houston, TX

Section 7428(c) Validation of Certain Contributions Made During Pendency of Declaratory Judgment Proceedings

Announcement 2003–65

This announcement serves notice to potential donors that the organization listed below has recently filed a timely declaratory judgment suit under section 7428 of the Code, challenging revocation of its status as an eligible donee under section 170(c)(2).

Protection under section 7428(c) of the Code begins on the date that the notice of revocation is published in the Internal Revenue Bulletin and ends on the date on which a court first determines that an organization is not described in section 170(c)(2), as more particularly set forth in section 7428(c)(1).

In the case of individual contributors, the maximum amount of contributions protected during this period is limited to $1,000.00, with a husband and wife being treated as one contributor. This protection is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for the revocation. This protection also applies (but without limitation as to amount) to organizations described in section 170(c)(2) which are exempt from tax under section 501(a). If the organization ultimately prevails in its declaratory judgment suit, deductibility of contributions would be subject to the normal limitations set forth under section 170.

Del Oro Conservatory for the Classical
Arts of Music and Dance, Inc.
Chandler, AZ

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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